The New York Certified Public Accountant

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BOOK REVIEWS

Accountants' Office Manual

By Charles S. Rockey. PRENTICE-HALL, INC., New York, N. Y., 1952. Pages: ix + 362; $6.35.

The operation of an accounting practice is characterized by the great responsibilities assumed towards clients, credit grantors, investors, the public, and to the profession itself. As a consequence every aspect of administration requires unusually diligent supervision and control. Sound policies, consistent with the standards of the profession, must be established and their continuous observance by partners, office employees and accounting staff must be checked.

Moreover, the professional aspect of accountancy requires that all activities conform to the highest standards of practice, personal conduct, confidential relationships, and the public good.

For these reasons the job of administration (apart from activities dealing with expansion of the clientele) is one of great magnitude. In firms of small size (few partners and employees) the problem of supervision is most serious, and often not adequately carried out because the partners are too busy in the field, managerial help is not always financially possible, or the need is not recognized. As such firms grow, administration improvements may lag because of continuing time pressures. Even where deficiencies are recognized, the measures to be taken are not always easily determinable.

If one could only be led (a behind the scenes, guided tour) through the office of a well-established accounting firm, see every activity, observe the coordination of partners and employees, examine every form and control device, and make a permanent record of everything seen and heard, that would certainly be an enormous aid, even if some adaptations to the needs of the tourist had to be made. Mr. Charles S. Rockey, C.P.A., by means of a recent book "Accountants' Office Manual", using his own well-established office as the exhibit, and supplemented by knowledge of the functioning of many other accounting offices, offers this guided tour, answering questions and making explanations.

While a major portion of the book is devoted to administration practices and forms, considerable attention is given to the subject of organization of a firm and partners' relations (Chapter 1). This should be of interest to those who are planning to start an individual practice or enter into a partnership.

The author ably, and painstakingly, presents a step-by-step description of the initiation, development, and operation of an accounting practice. Supplementing these data are 58 forms and charts, and an appendix containing 9 important exhibits. The supplementary data alone may richly reward the reader of this book, because of the important and uncommon information it contains. This

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is a list of the forms included in the appendix:

1. Form of partnership agreement
2. Clients' permanent file
3. Internal control questionnaire
4. Forms used by staff and explanation of their use
5. Audit program questionnaire
6. Profit-sharing plan
7. Profit-sharing trust agreement
8. Instructions for typists
9. Employees office manual

A glimpse at the table of contents will disclose, modestly, the large area covered by the author.

Chapter

1. The Firm and Its Organization
2. Specialized Departments
3. The Client
4. Auditing and Reporting Policies and Practices
5. Personnel
6. Office Policies and Procedures
7. Supplies and Equipment
8. Accounting for Income and Expenses

It is quite apparent that the author is dealing essentially with a large firm as the basis for his material. Accordingly there are references to the duties of a firm secretary, office manager, report and letter supervisor, managing partner, and a few others unknown to smaller organizations. An individual, or a firm, just starting a practice would be overwhelmed by the apparently enormous range of administrative problems disclosed just by a review of the table of contents, the appendix, and the index. Nevertheless, the smaller practitioner would find much of immediate benefit and a great deal for future guidance.

There is one subject that is touched on lightly, undoubtedly with disappointment to some readers. It is the question of how to get more and better clients. However, more attention is paid to ways and means of retaining clients, a matter of no small importance.

The author makes it clear, and so does Frank Wilbur Main in his foreword, that there is no one way to manage or systematize an accounting practice. There unquestionably are numerous instances where variations of described procedures and forms will occur to a reader. This is no reflection on the book but merely a manifestation of the diverse personalities, clienteles, and services that are represented in the accounting field.

The material is presented simply, in lucid fashion, and in almost conversation-like nar-

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rative. It should be invaluable as a guide to accountants who are suffering with "growing pains" and all others who would like to check their own practices and forms with what might be called a criterion.

MAX BLOCK

New York, N. Y.

Operating Results of Department and Specialty Stores in 1951 (Bul. No. 137)

By Malcolm P. McNair. Division of Research, HARVARD BUSINESS SCHOOL, Boston, Mass., 1952. Pages: vi + 66; $5.00.

This is the 32nd Annual Report of Operating Results of Department and Specialty Stores and it covers the year 1951.

As usual, there are tables comparing the results in 1951 with those in 1950 for sales, gross margin, expenses, and earnings. There is also a comparison of the 1951 results with those for the year 1939 and those for each year commencing with the year 1944. The data is given also by size of store and separately for department and specialty stores. There is a section entitled "Special Analyses" which deals with such subjects as the effect of branch store operation, LIFO results, and Federal Reserve district comparison.

A new section, entitled "Some Improved Approaches to Expense Control", explains how some of the stores have been moving into the field of cost accounting by the use of productivity measurement. Under the new method, which is known as "work center accounting", the operating expenses are grouped by work centers; costs and productivity totals are then compared by these centers. This is a development of recent years which may have important results.

The numerous statistical tables and the discussion accompanying them, as usual, are excellent. The report will again be found to be of inestimable value to those in the department store and specialty store fields.

J. P. FRIEDMAN

New York, N. Y.

Planning and Developing the Company Organization Structure

By Ernest Dale. AMERICAN MANAGEMENT ASSOCIATION, New York, N. Y., 1952. Pages: 232; $4.50 ($3.00 to A.M.A. members).

Here is a book that should be in the hands of anyone concerned with the organization of a business. It is the result of a survey conducted by Ernest Dale for the American Management Association. Its thesis is that one of the most striking developments of the present day is the application of systematic methods, such as carefully developed plans and well-ordered arrangements, to the conduct of business. In obtaining data, Mr.

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Society member, broad experience will handle Canadian assignments on per diem or other mutually satisfactory basis. Box 515, New York C.P.A.

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BUSINESS AND PERSONNEL OPPORTUNITIES

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BUSINESS OPPORTUNITIES

New member, 32, personable, finest references, seeks association leading to partnership with overburdened practitioner, conscienticus, will invest if necessary. Box 517, New York C.P.A.

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C.P.A., Society member with competent staff of eight, seeks partner with solid background. Investment required. Box 524, New York C.P.A.

Practicing C.P.A. requires office space in midtown NYC with possibility of sharing services of Junior Accountant. Box 525, New York C.P.A.

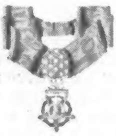
C.P.A., 34; minimum $12,000—annual gross; seeks partnership to expand for mutual benefit. Box 526, New York C.P.A.

SITUATIONS WANTED

C.P.A.—25 years experience, with old established practice, suddenly physically handicapped and unable to get about. Seeks opportunity for detail work, reports, taxes, etc. Will charge very reasonable fees in exchange for having work brought to home. Box 512, New York C.P.A.

Tax Assistant position desired by attorney with accounting degree. Experienced tax research, preparation of various returns, estate and corporate matters, government regulations. Knowledge excess profits; moderate salary. Box 516, New York C.P.A.

Per Diem—C.P.A., 32, National, to Small firm experience, 10 years. Available to seven days monthly. $20. Box 522, New York C.P.A.



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Dale visited forty top companies considered to have harmonious organization structures and spot-checked one hundred and fifty others on specific questions.

This book summarizes his findings in such a way as to point out the trends, the line of thinking, that would be of greatest help. Part I is a discussion of the dynamics of organization: the problems to be met at various stages of growth; methods for determining objectives; the delegating of responsibility; ways to reduce the executive's burden; the coordination of management functions. Part II deals with the mechanics of organization and offers guidance for analyzing a business structure and modifying and changing it.

The wealth of documented material is such that a brief review cannot attempt to discuss it all. The study is rich in concrete instances with illustrative quotations taken from varied authorities. A few observations may serve to show the value of the survey. There are certain trends noted: a definite movement away from one-man rule, and towards group decision making; increasing centralization of controls to check whether the delegation of authority is working out well; conflicts between staff and line with more staff people trying to assume line authority; increasing span of control, with more people having access to the chief executive, but with few having constant supervision; greater interest in studying the impact of the chief executive on the organization; a trend away from the "earthquake approach" of organization change, with reorganization occurring more gradually. Another point stressed is the importance of personnel, the recognition of the personal worth of each individual, the question of careful consideration of all the factors involved in choosing a worker, whether he be top man or artisan.

Perhaps the best way to point out the many values of this book is to quote from the introduction:

"Definition of Organization Planning

"Organization planning is the process of defining and grouping the activities of the enterprise so that they may be most logically assigned and effectively executed. It is concerned with the establishment of relationships among the units so as to further the objectives of the enterprise. The following basic characteristics of organization should be kept in mind in any discussion of organization planning:

"1. Organization is a planning process. It is concerned with setting up, developing and maintaining a structure or pattern of working relationships of the people within an enterprise. It is carried on continuously as changes in events, personalities and environment require. Thus organization is dynamic. However, the resulting structure is static—i.e., it reflects the organization only as of a given moment of time.

"2. Organization is the determination and assignment of duties to people so as to obtain the advantages of fixing responsibility and specialization through subdivision of work.

"3. Organization is a plan for integrating or coordinating most effectively the activities of each part of the enterprise so that proper relationships are established and maintained among the different work units and so that the total effort of all people in the enterprise will help accomplish its objectives.

"4. Organization is a means to an end. Good organization should be one of the tools of accomplishing the company's objectives, but it should not become an objective in itself."

WERNER E. REGLI

New York, N. Y.

THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

The matters contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.

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Expediting the Accountant's Office Work Through Mechanical Reproduction Methods

By JACK H. KLEIN, C.P.A.

This paper makes some very valuable suggestions for the elimination of typewriting and proofreading bottlenecks in the accountant's office, which are particularly acute during the busy tax season.

THERE are two office procedure problems facing us today. One is the shortage and consequent high cost of competent office help, which is particularly acute in the case of statistical typists. The other is the extreme difficulty in getting all of our work done during the tax season.

Under the circumstances, we face the need to examine our office procedures with a view towards reducing unnecessary work and, above all, eliminating that work which is a duplication of effort.

> JACK H. KLEIN, C.P.A., partner in the firm of Aronson & Oresman, CPAs, has been a member of the Society since 1944, and is serving on our Committee on Administration of Accountants' Practice. He is also a member of the American Institute of Accountants and the National Association of Cost Accountants.
>
> This paper was presented by him at a session of the 19th Annual Conference of the Society held June 18, 1952, at Saranac Inn, New York.

High on the list of duplications of effort is re-writing of information. Stop and think for a minute! Every single report or tax return which comes from the statistical typist's typewriter is a re-writing. She is copying the writing of some other person, in the form of a report draft, a pencil copy of a tax return, or a handwritten supporting schedule. Furthermore, if more than ten or twelve copies of a report are needed, the entire typing process must be repeated.

Beyond this, we must add to the typing time the time required to stuff carbons, joggle sheets, insert them into the typewriter, realign them and unshuffle carbons. This time has been estimated at from 17 to 55% of typing time depending upon the number of copies and quantity of typed material.* When we add to the typing time the time required to proofread, make corrections, etc., the stimulus to try to save time becomes very great indeed.

The answer to the problem of clerical

* N.A.C.A. Bulletin, February, 1943, page 658.

time-saving is to strike at its roots, namely, to eliminate re-writing whereever possible. This can be done, to a large extent, by using mechanical duplicating equipment to do the re-writing job, reproducing either typed material or handwritten originals of tax returns and their supporting schedules.

For reports, an original can be typed for reproduction to as many copies as are needed. This eliminates the time spent inserting carbons and the retypings required to make many copies, as well as the additional proofreading.

For tax returns, the handwritten return is itself used as the master, for direct reproduction of copies without typing. Here the biggest factor to be considered is the acceptability of a reproduction of a handwritten return, which is inherent in these processes. If this is not considered acceptable (i.e., the saving in clerical time is not felt to warrant the sacrifice of appearance) the uses of mechanical reproduction are more limited. However, even here, consideration should be given to the acceptability of handwritten supporting schedules, such as those for capital gains and losses, depreciation, borrowed capital, dividends, interest income, contributions, etc., the typing and proofreading time of which may often exceed that of the basic return itself. These schedules can be filled in on preprinted masters.

If handwritten material is completely unacceptable, there are still advantages to typing a master. In making copies of the return, it is often difficult to get clear copies due to the nature of the paper. Furthermore, the alignment of carbons and extra forms is difficult and if not done properly, the information may appear on the wrong line, or be obliterated. Finally, the master can be saved to prepare additional copies at a later date.

It is noteworthy that the trust departments of at least four large New York banks, which prepare hundreds of returns each year, are making copies of handwritten returns and filing the ink originals with the collector.

If a handwritten return is acceptable, it will save time during the crucial tax season. It makes possible better service to the client by freeing the office staff to expedite other important work.

Methods of Reproduction

There are two basic methods of mechanical reproduction which can be used, both of which turn out a high quality product.

1. "Diazo" Processes

The *"Diazo"* processes are essentially photographic. The material is exposed to ultra-violet lights and developed by chemical vapors or contact with a developer. This process is used in the *Ozalid, Bruning, Revolute, Pease* and *Spee-Dee* machines. Any material typed, written or printed on translucent paper (one side only) can be fed into the machine by hand, and will produce a copy, fed out of the machine mechanically, automatically developed and ready for use. Each insertion of the master will produce a copy. The operation is reasonably fast for tax return work, where a small number of copies is required. Any copy may be run by just inserting it in the machine. The machine will copy any size paper normally used for reports as well as tax returns of all sizes. It is more costly to operate than other reproducing apparatus using ordinary paper, since it uses a sensitized material. This limits the usefulness of this type of machine where large runs are required, because of the time required and the cost of sensitized paper.

In using this process for tax returns, the original return is prepared in longhand on translucent paper, so laid out that all printing and writing is on one side only. This is fed into the machine to produce a copy.

There is one serious drawback to this simple process: The Treasury Department will not accept the copies made this way, as the sensitized paper does not meet government standards. An

effort is being made to overcome the department's objections and secure approval. In the meantime, however, copies can be made for the firm and its clients and the originals filed. The latter are acceptable to the collector.

In sum, this is a desirable reproductive process with little limit on sheet size and no trouble in setting up and operating.

2. **The Offset Process**

This process is essentially a printing method, represented principally by the *Multilith* and *Davidson* machines. Instead of type, a paper duplicating master (or a thin zinc master for larger runs) is used, from which reproduction is made onto a blank paper of any grade and weight (except very light weight onion skin). The duplicating master will print anything typed, written or imprinted on it. Thus, a report can be typed on a master and as many copies run off as desired.

For tax returns, a pencil copy is prepared on a master containing a preprinted tax form and run off on blank paper. Both the tax form and the handwriting will be reproduced.

This process has two advantages:

1. Tax Returns reproduced by this method are acceptable to the Treasury Department for filing.

2. The machines can turn out a high volume of copies quickly and at a low cost for materials.

Some disavantages of the Offset Processes are:

1. Setting up the material to be run is more cumbersome than the "DIAZO" processes. For each page to be run, a master must be placed in the machine and dampened with a fluid. This is less of a drawback for larger duplicating runs than it is for tax returns, where only a few copies of a page are needed. However, compared with the time lost by *not* using a duplicating process, this is not a decisive drawback.

2. The size of the paper which can be run is limited unless a very large and expensive machine is used. The most practical machine (which costs about \$2,300.00) will take 9¾" × 14" material. Handling a 9" × 16" corporation tax return is rather cumbersome with this model, but can be done. Report pages of double width can be handled only by using two masters, making two separte runs for each such page. This is not a decisive drawback for corporation returns since reproduction of the supporting schedules will save much of the work involved in typing such returns.

Supplementary Uses for Duplicating Equipment

In addition to a primary utility for reports and tax returns, each type of equipment has certain supplementary uses which are valuable in an accountant's office.

1. *"Diazo" equipment* can be used to reproduce standardized audit worksheets, dummy statement forms and skeleton forms, ahead of the time when needed for the audit. For example, the accountant can go to the client's office equipped ahead of time with trial balances, lead schedules, bank reconciliation forms, petty cash reconciliation forms, insurance schedules, other supporting schedules, and schedules for the reports. These worksheets can be prepared complete with column headings, account titles, and special instructions to the accountant, ready for him to insert figures. This can be a source for large savings in staff time, since it frees accountants for work more in keeping with their skill. The forms and worksheets can be prepared just once on translucent work sheet paper available for these machines, then copied as needed.

2. *Offset equipment* can be used, as is "Diazo" equipment, for standardized worksheets but subject to the size limitations previously mentioned.

This process has another advantage in that it gives the accountant's office a

high speed printing press of its own, capable of turning out high volume, high quality work at low cost. The machine can be a source of economies in the following types of work:

- Printing many office forms which now are composed and printed outside.
- Printing confirmation letters.
- Printing form letters and instructions to clients.
- Printing special statement forms.
- Printing staff manuals and informaation bulletins.
- Printing newsletters to clients.

Facts and Figures About the Machines

Now for a few facts and figures about the machines, and what they cost:

1. *The Offset Process** requires a basic outlay of between $900 and $4,000, with a machine suitable for all of the work described costing about $2,300. This machine will weigh 640 lbs., and will require a floor space of 27" × 60". It will take paper up to 9¾" × 14". A larger machine will take paper up to 17" × 20". These machines will produce 80 to 100 copies per minute, once they have been set up.

The cost of a paper master will be $.05. Since the machine uses ordinary blank paper, the cost of making large runs is very low, adapting the process to many duplicating and printing jobs.

Any person can run the $2,300 machine with little training. The very large machine requires a skilled male operator.

2. *The Diazo Process* requires a machine costing $1,475 up to $5,000. The $1,475 machine is satisfactory for the applications discussed. It weighs 810 lbs., and takes up one square yard of floor space. Speed of production will depend on the operator's dexterity, since masters and sensitized paper must be fed and removed by hand. This is slower than the automatic feed of an offset machine. However, any person can operate the machine.

The cost of sensitized paper is $.01 to $.02 per square foot, which makes the process more economical for short runs than the offset method. However, for large runs the cost of sensitized paper as against ordinary blank paper will weigh against it.

Some, but not all, *Diazo* machines have the drawback that they give off heat and chemical fumes, requiring special ventilation outlets. One maker has assured us that this is not the case with his machine.

Although the economies achieved through reproducing equipment will vary with the size of the accounting office and type of practise, I feel it at least warrants consideration by all practitioners.

* The March, 1952, issue of The Journal of Accountancy has an excellent article by Mr. Bernard B. Isaacson, describing the uses to which his office has been able to put an offset machine.

AN ADIRONDACK VIEW

Wandering Thoughts hatched while looking at October's flaming leaves.

1. We thought that election campaigns were opportunities to show the voters the qualifications of the various candidates. Instead they seem to be used to show what a worthless guy the other candidate is. It may be smart U. S. politics but it sure does not look like wise world leadership.

2. College professors are frequently made fun of profusely—but everybody wants to send their kids to college.

3. The $100 we get for the $75 we put into those savings bonds won't buy now what the $75 would then—but we hear of no scramble to donate these maturing bonds to the Community Chest or the Boy Scouts.

4. When Thanksgiving Day comes, if you have nothing else to be thankful for you can be thankful that the election is over: that we had it; that many people are willing to be college profs; and that $100 will still buy a lot of many things—without standing in line.

LEONARD HOUGHTON, C.P.A.
Adirondack "Chapter"

Accounting Judgment

By Gilbert R. Byrne, C.P.A.

Judgment is a mental tool of great importance to the auditor. It must be based on verifiable facts weighed without bias in the light of experience, and its exercise implies the use of foresight by the auditor. It is not the same as logic, and generally its quality is assessable only after the passage of time.

Students of accountancy and those beginning its practice are constantly reminded by their preceptors of the importance of the exercise of judgment in the work which they are or will be called upon to do. Some of them may be puzzled as to exactly what the term implies; accountants of greater experience may also be interested in a discussion of the relation of the exercise of judgment to the practice of accountancy.

As generally used in accounting, the exercise of judgment implies making a choice among two or more courses of action. The auditor is constantly making choices among possible methods of assuring himself of the essential validity of the results of accounting procedures followed in arriving at account balances; and having determined upon the auditing procedure to be followed, he exercises judgment as to the extent to which he should apply such procedures. The auditor often must choose which of several generally accepted accounting principles is, in his opinion, applicable in the circumstances; he must use judgment in determining the form, content and wording of financial statements. In his own report, he must exercise judgment in determining whether and to what extent explanations or exceptions are necessary; he chooses carefully among alternate methods of expression, and sometimes decides whether he may properly give any opinion at all.

Gilbert R. Byrne, C.P.A., has been a member of the Society since 1936; he has served on various committees and at present is chairman of the Committee on Publications.

He is a graduate of the University of Michigan, and is a staff supervisor of Lybrand, Ross Bros. & Montgomery, CPAs. He acted as Editor of the Sixth and Seventh Editions of "Montgomery's Auditing."

Judgment is characterized in many different ways. We read of good, wise, experienced, informed, educated judgment; and sometimes of misguided or bad judgment. There must be a proper basis for the exercise of judgment which will tend toward the formation of good judgments; there may be a method by which the quality of judgments may be measured.

Facts as a Basis for Judgment

A man's judgment, it is said, is no better than his information. The process of choosing among two or more courses of action, therefore, starts with ascertaining all the facts relating to the question to be resolved. For example, before determining the audit procedures to be followed in reviewing inventory costs, the accounting procedures and costing methods—whether job, process, standard, etc.—must be known in considerable detail. If judgment is to be exercised in respect of the required accrual for federal income and excess profits taxes, in addition to a proper computation of the current year's liability, the status of all open years must be known. Examples could be multiplied, but it is obvious that if the facts are wrong, judgments based upon them will likewise be bad.

No one knows better than the experienced auditor that it is difficult to

obtain all the facts relative to a particular question. Many facts must be obtained by discussions with company employees or officers. Oral transmission of information is subject to all of the disabilities inherent in human relations, both because the speaker does not always define precisely his meaning, and because the listener sometimes fails to discount his own preconceived ideas of what he expects to hear. The auditor will always, when possible, confirm his understanding by reference to documents, but even documentary evidence, especially when in the form of contracts, agreements, tax returns and the like, is subject to varying interpretations of meaning. When faced with the necessity of exercising judgment in any of the areas of his work, the auditor will check and double check his facts to be sure that the foundation for his judgment is on solid ground.

Judgment Is Aided by Experience

Facts are essential to judgment, but they are not enough. Samuel Johnson said

> ". . . I knew almost as much at eighteen as I do now. My judgment, to be sure, was not so good, but I had all the facts."

The element which the good Doctor then lacked was experience. Such experience is that which produces an "effect upon the judgment . . . by personal or direct impressions as contrasted with descriptions or fancies." The auditor checks his judgment, consciously or unconsciously, against his experience. He also refers to the accumulated experience of his predecessors and contemporaries as preserved and reported upon in accounting literature. His judgment, in other words, is affected by his experience, and the recorded experience of others; if the experience has been extensive and well absorbed, its effect should be to improve the quality of the judgment. To revert to a previous example, the auditor's judgment of a proper amount for accrued federal income and excess profits tax at a balance sheet date would be sounder if he had had experience not only with the tax law, regulations and cases, but also with the habits and probable attitudes of the personnel in the Bureau of Internal Revenue. Again, all persons having to do with the preparation of financial statements endeavor to present them in such form and in such language as will be most understandable to the reader, and to include all material facts. Experience as a reader and analyst of financial statements is certainly necessary to the formation of judgments in this area. Further, the "average prudent investor" is included in the audience to whom most financial statements are addressed, and financial statements included in Registration Statements under the Securities Act of 1933 are intended primarily for this somewhat amorphous figure. When judgments are formed as to what facts are material to the average prudent investor, or in what form and language the financial statements should be prepared so as to be most intelligible to him, it is certainly a fair question whether judgments of those without experience *as investors* are sound.

Judgment vs. Logic

Judgment is not the same as logic, or straight thinking. Both are mental processes, but they differ greatly in characteristics.• Logic and judgment each require facts as a basis; but logic leads to conclusions based on deductive and inductive reasoning from facts, while judgment weighs facts and balances probabilities in the light of experience with similar or analogous situations. Accounting principles and audit procedures are formulated by logical reasoning; judgment selects one alternative for application among several which may be under consideration. To the accountant, logic is an important mental tool and he should be skilled in its application; one of the tests he applies in exercising judgment among alternatives is whether and to what extent each is supportable in logic.

The difference between logic and judgment is illustrated by the brilliant sophomore who as a dogmatic rationalist is impressed with radical causes, perhaps as a result of his oversimplified reasoning. Usually we find that his more mature and experienced judgment leads to a revised estimate of his earlier enthusiasms. As Professor Brinton put it, "his callow youthful confidence in the power of rational evidence (has) yielded to experience." The junior accountant may have logic on his side in discussions with his seniors, but the experience of the latter often points out considerations which lead to a judgment differing from that based solely on logic untempered by such experience.

A favorite subject for discussion years ago was "Is accounting a science?" Accountants today would consider this question of no interest, because they would think it axiomatic that accounting is not "a branch of study concerned with observations and classifications of facts, especially with the establishment of verifiable general laws, chiefly by induction and hypothesis;" for example, mathematics. While accounting principles or rules are being established by methods at least analogous to those of a science (including logic or inductive and deductive reasoning), the application of these rules is still very largely a matter of judgment, as is, of course, true in many other fields. It is because there are large and important areas of the practice of accounting in which the exercise of judgment is paramount that leads most accountants to agree that it cannot yet be practiced by scientific rule.

Judgment Should Be Unbiased

The proper insistence upon independence of judgment on the part of the public accountant who reports upon financial statements is essentially a requirement that his judgments be free from bias arising from any source. In the volumes of comment which have been written on this subject, greatest emphasis has been placed on the impact of financial or personal interest on the accountant's judgment. But Alexander Hamilton in the first Federal paper spoke of

> . . . the honest errors of minds led astray by preconceived jealousies and fears. So numerous indeed and so powerful are the causes which serve to give a false bias to the judgment, that we, upon many occasions, see wise and good men on the wrong as well as the right side of questions of the first magnitude to society.

Of the causes serving to give false bias to accounting judgments, the effect of a man's entire background and experience has not perhaps been fully realized. In this sense, experience includes environment, education, and all of the social contacts which lead to economic and political beliefs, the whole of which affects a man's judgment. For example, many accountants feel that some court decisions in the field of income tax law reflect poor judgment. This opinion is certainly affected by their training and experience as accountants, and it is equally certain that the judge's opinion is affected by his background of legal training and experience. Further, the accounting judgments of those whose training has been in the fields of accounting education, government accounting, or business or professional accountancy are shaded by their respective backgrounds of experience. Whether in any instance the shading is sufficient to amount to bias or whether it merely results in a proper difference of opinion may itself be a matter of judgment. An illustration of a possible source of bias which may have colored judgment is an incident discussed editorially in the Journal of Accountancy (Vol. 92, p. 164). A trade union official was critical of corporate financial statements, stating his opposition to any evidence of conservatism in accounting, and to the charging of management compensation to income. Whether those judgments are good or bad, and whether it is necessary or desirable that

accounting judgments from this source should be impartial, is not considered here. It does not, however, seem likely that these judgments are free from the bias which stems from the spokeman's background of education, experience, and social contacts in labor union work.

It is important to eliminate financial and personal interests of the public accountant as a possible source of bias which would improperly color his judgment; it may be equally important to weigh the possible effects of his education, training, experience, and the position from which he speaks.

Judgment Implies Forecasting

It has been said that the exercise of judgment implies making a choice among two or more courses of action. When the choice is made of course A, rather than B or C, it follows that it is believed that such course will best attain the end sought. If the choice made is among alternate audit procedures, the one chosen is that which it is believed will best assure the auditor of the essential accuracy of the account balance; if the choice is among accounting principles, that is chosen which it is believed will most fairly present the position and results of operations; if a matter of form and wording of financial statements, the choice will be that which it is believed will most clearly present the data to the reader. An estimate of the future result of present decisions is essential to the process of exercising judgment. A common example is that of estimating the amount to be reflected in a balance sheet for accrued liabilities, the precise amount of which cannot be determined until a later date. Many such accruals can be estimated largely on the basis of the company's past experience, as for product guarantees. Often, however, the introduction of new products or other factors produce conditions which must also be considered in forming judgments as to what the future cost of making good product guarantees will be. Accruals of expected refunds under price redetermination clauses of government contracts, and under the Renegotiation Act, are necessarily estimates of the final outcome of negotiations with the appropriate government officials, based on present knowledge of the facts and on experience in such matters. When the auditor decides whether a particular item is of such character and relative amount that it should be separately stated in the income account, he is estimating what the effect of disclosure or nondisclosure will be on the thinking of a future reader of the statement of income. The auditor is thought of as a man of facts and figures; he scrupulously avoids estimates of future earnings, and his preparation of pro forma financial statements is narrowly limited. There is something ironical in the recognition that in his formation of accounting judgments, so important a part of his work, the auditor is necessarily forecasting the future.

Time Assesses Judgments

All judgments at the time they are made are thought to be good judgments by those making them. On the basis of the facts then known, considered in the light of experience at the time, it may have been generally agreed by many others that good judgment *was* exercised. But the exercise of judgment implies a present estimate of the results of future happenings; the quality of judgment therefore, cannot be finally assayed until time has revealed the soundness of the estimate. For example, time has proved the soundness of many audit procedures which have been recorded in accounting literature as the experience of early practitioners. On the other hand, for years it was the judgment of many auditors that confirmation of accounts receivable and physical tests of inventories were not necessary to the formation of an opinion on financial statements. As is well known, with the passage of time, developments convinced the profession that such judgments were not sound. The

Committee on Accounting Procedure of the American Institute of Accountants has recently amended certain previously issued Bulletins, indicating that subsequent developments dictated revision of its earlier judgment. An estimate of accrued liability for renegotiation may have been honestly and competently made at a year end, and the judgment exercised as to the amount approved by the independent auditor. But a wager on the quality of this judgment could not have been paid when the judgment was exercised; only when the renegotiation refund is actually determined can one definitely say whether the judgment was good, poor, or median.

In some areas of the exercise of accounting judgment it is difficult if not impossible to grade its quality by comparison of its present estimate with future actuality. For example, the auditor's best judgment is exercised to the end that the form, content and wording of financial statements are intelligible to the reader, and that the inferences drawn by him are those intended to be drawn, and no inferences are drawn which were not intended. Unfortunately, only in a very limited way is it possible to determine whether the choices made in deciding between alternative presentations or wordings achieved this desired result. Even if a poll were taken of the reactions of a sampling of readers, it would probably be found that individuals reacted very differently. Admittedly it is difficult to assess the value of judgments in these matters. It is possibly for this reason that the pundits speak freely on the subject of what the reader of financial statements requires. If in these areas the mere passage of time does not permit an assessment of judgment quality, it may be that its worth may be indicated by inquiring whether the opinion comes from one whose experience has been appropriate to the subject matter.

Conclusion

To the independent public accountant, judgment is his reasoned estimate, based upon (1) the facts presented to and independently reviewed by him, and (2) his experience and the reported experiences of others, of the probable result of choosing one course of action out of two or more presented for consideration. The quality of judgment usually can be assessed only after the passage of time permits comparison of the forecast with the performance. A man of good judgment, therefore, is one skilled in the ascertainment of facts, with the knowledge and experience to weigh and assess the probable consequences of action based on them, whose record over an extended period of time indicates a high percentage of judgments confirmed by subsequent events.

Can Stock Redemptions by Family Corporations Escape the Grasp of Section 115(g)?

By Julian S. H. Weiner, C.P.A.

Here is a provocative article dealing with the very controversial section 115(g) of the Internal Revenue Code. The author suggests a plan for avoiding the impact thereof upon stock redemptions by closely held corporations. Some readers may not entirely agree with him, but then that is what makes tax cases.

The crushing impact of the Revenue Act of 1951 upon corporate profits has detracted considerably from the appeal of this form of business enterprise. The blow has been particularly severe for closely-held corporations. Such entities are generally created for the express purpose of rescuing substantial incomes which would otherwise be engulfed by the upper surtax brackets. Heretofore, the tax-wise benefit derived from the use of the corporate shield has, in the main, outweighed the burden of double taxation imposed upon corporate income. The recent tax boosts, however, have in many instances tipped the scales in the other direction. Hence, this will furnish stockholders in family corporations with a greater incentive to minimize the consequences of the dual tax feature. This goal is usually attained by attempting to distribute corporate earnings to stockholders in some form other than dividends. Thus, such funds would not be taxed as ordinary income to both the corporation and the stockholders. Foremost among the methods employed to effect this desired disposition of profits is that of stock redemptions. The purpose of this device is to convert ordinary income to a capital gain. Unfortunately, such plans have been frequently challenged by the Commissioner under Internal Revenue Code Section 115(g), on the grounds that the distribution is essentially equivalent to a distribution of a taxable dividend.

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In view of the complexity of this subject, a comprehensive review of its ramifications would be beyond the scope of this article. However, since the problem is often encountered in connection with a corporation controlled by a single common stockholder, the following discussion will be confined accordingly. Therefore, the specific question considered hereafter is whether a corporation can redeem part of its common stock from its sole shareholder at an amount in excess of par value[1] without converting the redemption to an ordinary dividend. Before proceeding to the recommendations, it

[1] This is not to say that no problem is present if the redemption is at or less than par value. The discussion herein is merely limited to the question set forth above.

would be expedient to examine the pertinent statute and regulations in order to comprehend fully the nature of the issues involved.

Controlling Provisions of Internal Revenue Code and Related Regulations

Section 115(g) of the Internal Revenue Code provides that—

> "If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913 shall be treated as a taxable dividend."

It is noteworthy that the statute does not define the term "essentially equivalent to the distribution of a taxable dividend." Hence, the Commissioner of Internal Revenue may exercise his discretion, within reasonable limits in the application of the statute to a given transaction.

Reg. 111, Sec. 29.115-9 casts some light upon the position assumed by the Treasury Department on this matter. Pursuant to the regulation,—

> "The question whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to the distribution of a taxable dividend depends upon the circumstances of each case. A cancellation or redemption by a corporation of a portion of its stock pro-rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of earnings and profits accumulated after February 28, 1913."

The regulation specifically classifies a pro-rata redemption as a taxable dividend. Naturally, any cancellation of stock belonging to a sole shareholder would be viewed as a pro-rata redemption. Hence, the stockholder in our hypothetical case could not avoid the consequences of Section 115(g). The question then arises whether there is any other means of extricating our stockholder from his predicament. Generally, no suggested remedy would be effective unless it could be fashioned out of the material contained in the regulation. Hence, it would be appropriate, at this junction, to resume our examination of Sec. 29.115-9. Continuing from the terminus of the previous extract, the next subdivision states that,—

> "On the other hand, a cancellation or redemption by a corporation of all the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend."

Accordingly, the bailing out of an entire stockholder's interest would not be treated generally as a taxable dividend. This provision, therefore, suggests a method of avoidance requiring a diversity of corporate ownership.

Introduction of an Additional Stockholder

The conversion from single to multiple ownership is not difficult to accomplish. The problem is to select the most effective means, tax-wise, of achieving this objective. The obvious method would be to sell stock to an outsider and arrange for its subsequent redemption. This solution, however, may involve sharing the control of the business with an antagonistic party, thereby defeating one of the principal advantages of a closed corporation. Moreover, unless the planned redemption is supported by some *bona-fide* business purpose, the Treasury Department may treat the transaction as a sham designed for the evasion rather than the avoidance of taxes. Viewed in this light, the proceeds of the sale would probably be considered as a dividend distribution rather than a capital gain.

The obstacles inherent in the foregoing remedy may be by-passed by resorting to another avenue of approach. This latter course would lead

to a diversity of ownership created by a gift rather than by a sale of stock. Assuming our sole stockholder is a family man enjoying the blessings of domestic harmony, it is suggested that the portion of his stock intended for redemption be transferred to his spouse. Eventually, after the lapse of a reasonable period of time the stock held by the donee spouse should be redeemed. Thereafter, our shareholder may avail himself of the proceeds of the distribution by borrowing from his spouse under a legitimate business arrangement.

Tax Savings

What would be the extent of tax benefit should the proposed device succeed in hurdling the pitfalls of Section 115(g). For purposes of illustration, as of the date of the gift, let us assign a fair market value to the stock in the amount of $300,000. The gift tax payable by the donor, would be computed as follows:

Fair market value of stock	$300,000
Less: Marital Deduction (½ of f.m.v.)	150,000
	$150,000
Less: Exclusion	3,000
	$147,000
Less: Exemption (if no previous exemptions have been used)	30,000
Net Gift Subject to Tax	$117,000
Gift Tax on Above	$ 19,350

It should be noted that a fifty percent marital deduction is permitted on gifts made to one's spouse. Hence, the tax on such gifts would be considerably less than the tax on a gift to one's issue. As indicated in the above tabulation, the availability of the $30,000 exemption would be dependent upon its utilization in previous years.

The basis of the stock held by the donee for the purpose of computing gains is the donor's basis. Accordingly, upon redemption, the excess of the amount received by the donee stockholder over the donor's basis would be a capital gain subject to a maximum tax rate of 26%.

As shown below, the recommended plan would result in an over-all tax savings of approximately $140,000 when compared with the tax liability calculated at ordinary income tax rates.

Combined normal tax and surtax on net taxable income of $300,000 (joint return)		$230,432
Less: Gift tax (as computed previously)	$19,350	
Capital Gains Tax (donor's basis established at nominal figure of $25,000) 26% of $275,000	71,500	90,850
		$139,582

Tax Commissioner's Viewpoint

The above discussion clearly indicates the substantial tax benefit to be derived from the foregoing proposals. Therefore, it would be pertinent at this stage to consider the attitude of the Tax Commissioner towards the recommended *modus operandi.*

In this connection, a proposed regulation revising Section 29.115-9 which was published in the Federal Register October 9, 1951, heralds the Commissioner's position on this question.

The amendment contemplates the deletion of the following provisions,—

> "On the other hand, a cancellation or redemption by a corporation of all the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation does not effect a distribution of a taxable dividend,"

and the substitution in its place of the following amendment,—

> "On the other hand, a cancellation or redemption by a corporation of all the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, will generally not effect a distribution of a taxable dividend; however, where such shareholder is closely related to remaining shareholders, that factor will be considered along with all other circumstances of the case in determining whether the distribution is essentially equivalent to a dividend."

The proposed revision is a qualification of the former absolute statement that a redemption of all of the stock of a specific stockholder would not be deemed a taxable dividend. This hedging by the Commissioner would tend to jeopardize the plan whereby the stock of the donee spouse is to be redeemed. However, it is to be noted that the amendment has not yet been adopted as of this writing. Moreover, the contemplated revision preceded the 1951 Revenue Law enacted October 20, 1951, which reflected a more liberal congressional attitude towards family partnerships. The following is an extract from the Senate Finance Committee Report concerning family partnerships which reflects the legislators' purpose:

> "If an individual makes a bona fide gift of real estate, or of a share of corporate stock, the rent or dividend income is taxable to the donee. Your committee's amendment (Sec. 340(a), 1951 Act) makes it clear that, however the owner of a partnership interest may have acquired such interest, the income is taxable to the owner, if he is the real owner. If the ownership is real, it does not matter what motivated the transfer to him or whether the business benefited from the entrance of the new partner."

Accordingly, the analogy between the family partnership and the family corporation is extended to its very method of creation. Heretofore, the validity of a family partnership was seldom questioned where it truly represented, in fact as well as in form, an association of two or more persons to carry on a business as co-owners for profit. In the past, the family partnership was vulnerable to attack, generally, when it was created by a gift of a capital interest to a member of one's family. Therefore, the purpose of the new law was to assure legal recognition of such a partnership irrespective of the factors motivating the transfer of a partnership interest. Since this legal sanction was deemed to have existed with respect to other forms of business, a diversity of corporate ownership created by reason of a gift of stock, should accordingly be granted similar protection.

Much of the new law on recognition of a partner for tax purposes is in the Committee reports rather than in the statute. Therein Congress infers that the emphasis on tests for recognition should be shifted. It criticized results reached by emphasizing intention, business purpose, reality and control. It stresses that emphasis should be on actual ownership of a partnership interest.

Since the objective of the law, pursuant to the Committee report, is "to harmonize the rules governing interests in the so-called family partnership with those generally applicable to other forms of property or business", it clearly implies that the test of ownership to be applied to family partnerships is already recognized with respect to the corporate form of business. Hence, any attempt by the Commissioner to treat a family group as a single stockholder

unit, regardless of actual ownership by the separate members of the family would be contrary to the spirit of the law as expressed in the committee's report. Therefore, it appears that the proposed plan would not contravene legislative intent.

Judicial Precedent—Family Corporations

However, since statutory or legislative interpretation is a judicial function, it is necessary to ascertain the attitude of the courts with respect to the contemplated transaction. Accordingly, let us examine some of the case material concerning this subject.

In the *Estate of Ira F. Searle, The First Trust Company of Lincoln, Nebraska, Executor,* and in the *Estate of I. G. Chapin, Barbara D. Chapin and I. J. Chapin, Executors,* T. C. Memo Dkt. Nos. 24804, 10/31/50, the facts were as follows:

> "Stockholders of a lumber corporation were indebted to the corporation, the indebtedness continuing against the estates of these same stockholders upon the death of one and the adjudication of incompetency of the other in the taxable year. Executors of the respective estates agreed with the creditor corporation to sell stockholders stock to the corporation for a fixed price, and further agreed that the consideration received is to be credited to the accounts of the debtor-stockholders' estates."

Only enough stock was redeemed from the stockholder's estates to liquidate their respective indebtedness to the Corporation. The common stock was issued at a par value of $100.00. The redemption of the stock was at $403.75 per share.

The Commissioner contended that the proportional ownership of the stock by the two families did not change after the redemption, although the proportionate holdings of the wives and the estates of their respective spouses did change.

The Court decided that there was no merit to the Commissioner's contention because

> "the ownership of stock in a corporation rests in the individual who owns it, not the family to which he belongs. The regulation relates to the 'stock of a particular shareholder', not that of a family. Besides, the question here is not what effect the transactions had as to the proportionate ownership of the stock, but rather whether the proceeds from the transactions were distributed pro-rata among all of the shareholders." * * *

Based upon the foregoing grounds, the Court concluded that

> "the facts here clearly reveal that the transactions in question were bona fide sales made for the purpose of liquidating the indebtedness due the Company of two of its principal stockholders, one of whom had died and the other had become mentally incompetent, both occurring during the taxable year. Both the intention and net effect of the transactions was to liquidate such indebtedness and not to make a distribution of dividends."

What is the significance of the above decision with respect to our recommended mode of procedure? First, of prime importance, is the fact that the Court rejected the Commissioner's attempt to ignore individual ownership where family relationships are concerned. Secondly, the Court's opinion confirms the legislative intent, expressed in the Senate Finance Committee's report, with respect to family partnerships. Repeating the quotation cited previously,—"Section (340 of the 1951 Act) is intended to harmonize the rules governing interests in the so-called family partnership with those generally applicable to other forms of property or business." Thus recognizing the fact that the test of actual ownership to be hereafter applied to family partnerships has already been accepted for "other forms of property or business" such as the corporation. Finally, under this decision, it would appear that where more than one member of a family possesses a substantial proprietary interest in a corporation, a redemption from one stockholder would not be deemed a pro-rata distribution and, therefore, an ordinary dividend. In this connection, the Court stated:

> "While the absence of a pro rata distribution may not of itself exclude a transaction from the purview of section 115(g), yet since the Commissioner affirmatively provides that such a distribution 'will gen-

> erally be considered' sufficient to bring the transaction within the purview of the section, its absence would certainly be a circumstance, and we think here a cogent one, when considered with other facts of the case in determining the section's inapplicability."

The Court also discussed the case of *J. Natwick*, 36 B.T.A. 866, wherein the absence of a pro-rata redemption did not preclude a decision in favor of the Commissioner. The Court distinguished the said case on the ground that,

> "In the Natwick case, supra, the taxpayer when the corporation was created, owned all of the stock except two shares, one each being owned by qualifying stockholders, gifts of the taxpayer, and it was said that the corporation was under the absolute domination and control of the taxpayer and he was to all intents and purposes the sole stockholder."

Accordingly, the presence of another major stockholder, even though a member of the same family, whose stock would not be involved in the suggested partial redemption, should be sufficient to avoid the finding of a pro-rata redemption, which is one of the tests and characteristics of a dividend.

There is another recent case wherein the Treasury tried to treat a family group as a single stockholder unit, apparently regardless of the circumstances. The facts of the case, *Marie W. F. Nugent—Head Trust*, 17 T. C. 817, were as follows:

A corporation was originally owned by a father and son. On the father's death, his will gave all of his common and half of his preferred stock to his son. The remaining half of the preferred stock was placed in trust for the daughter as life beneficiary. Because of the drain of dividends by the preferred stock, the corporation decided to redeem it. Partial pro rata redemptions of the preferred stock were made in 1945 and 1947. The daughter actually went to Court in an attempt to keep the trustees from accepting the redemption. The Commissioner claimed that the redemption was a dividend to the trust and should be taxed as ordinary income.

In this instance, as well, the Tax Court blocked the Commissioner's line of attack by holding that the sister's trust and the common stockholders could not be considered together as a unit.

The factor of family relationship was also present in the case of *John T. Roberts and Florence V. Roberts*, 17 T.C., 171. This litigation involved the redemption of an entire block of stock which had been bequeathed to the petitioner, the surviving corporate shareholder, by his brother. The Court held that essentially, "it was the estate's stock, and no other, that was actually redeemed." The opinion cited *Clara Louise Flinn*, 37 B.T.A. 1085, wherein the Court had held that,—

> ". . . Here there was a complete liquidation of the holdings of but one shareholder owning a minority of the shares. The purpose was not to distribute earnings, but to bring about a separation of this one shareholder from the corporation."

In effect, therefore, the Court upheld the criterion of individual ownership and turned down the doctrine of family control favored by the Commissioner.

Judicial Precedent—Validity of Gift

It is important that the proposed transfer of stock be effected so that the bona fides of the gift cannot be challenged successfully by the Commissioner. For if the validity of the gift could not be sustained, the present stockholder would continue to be recognized as the sole stockholder. The redemption of the stock transferred to the donee would be treated as a redemption of stock belonging to the donor, and hence taxable as an ordinary dividend. Taxwise, the donee spouse would be deemed the recipient of a gift of the proceeds of the redeemed stock, rather than of the stock itself.

A review of the following cases will clarify the nature of this problem.

In *Bardach* v. *Commissioner of Internal Revenue*, 90 F(2d) 323, CCA-6, 1937, two sole stockholders had gifted the major portion of their stock to their wives. Thereafter, the stock was sold by the donee spouses. The Commissioner attempted to tax the profit on these sales to the donors. The

Court held that "there is nothing per se suspicious in connection with the gift of shares of stock by a husband to wife." Here, "the transfers were regularly made, properly reflected on the books of the corporation and were effective to vest legal title in the wives." The Court also decided that the deposit of the proceeds received from the sales of the stock in joint bank accounts maintained by the wives with their respective husbands was inadequate to invalidate the gifts.

In another case, *Otto Peterson,* 42 B.T.A. 102, petitioners, sole stockholders, in order to reduce their individual taxes, adopted as directors a resolution to sell treasury stock to members of their families at a price which was substantially less than the intrinsic value of the stock. The purchase of the stock was financed by the petitioners. All legal formalities necessary for the transfer of the stock were observed.

The Court decided that the "sole inquiry is whether, in fact, stock was owned by petitioners after its issue to the members of their families. If it actually belonged to members of petitioners' families, regardless of whether they acquired it by gift or purchase, dividends thereon are not taxable to petitioners." Here too, the existence of joint bank accounts was considered of slight significance inasmuch as the monies deposited therein by members of the petitioners' families were never used except as funds of the recipient.

Another case in point is *Becker* v. *Glenn,* 23 AFTR 711. The Court stated therein that "surrounding circumstances including subsequent acts of taxpayer may be inquired into in determining bona fides of the transaction. Where evidence establishes a completed gift and testimony of parties is unimpeached, the Court is bound to accept it."

In *Weil* v. *Commissioner,* 82 F(2d) 561; cert. den., 299 U. S. 552, the Court stated that the sole question is the completeness of the transfer of the property even though the motive of the gift was the avoidance of taxes.

Hence, the above decisions clearly indicate that a gift, which is perfected in fact, as well as in form, will be upheld even though the underlying factor therefor was the reduction of taxes.

In view of the foregoing material, there appears to be sufficient authority that the contemplated redemptions would be taxed as capital gains rather than as ordinary dividends.

Consequences of Proposed Plan

As indicated at the outset, however, the broad discretionary powers vested in the Commissioner have transformed Section 115(g) into one of the most highly controversial sections of the tax law. Unfortunately, this condition has often culminated in a divergence of opinion between the courts and the Treasury Department, thus impairing the value of the court decisions as an authority on the suggested transactions. Therefore, it is not recommended that the taxpayer assume the risk of litigation in order to test the effectiveness of judicial precedent on this subject. In this connection, the last section of Reg. 111, Sec. 29.115-9, provides that,—

> "In all other cases the facts and circumstances should be reported to the Commissioner for his determination whether the distribution, or any part thereof, is essentially equivalent to the distribution of a taxable dividend."

Hence, pursuant to the above authority, no redemption need be effected without the previous submission of an application therefor to the Commissioner of Internal Revenue. In order to anticipate all contingencies, let us assume that the said application is disapproved. Accordingly, an examination of the recommended plan will reveal that its only irrevocable feature is the contemplated gifts and the tax thereon. However, if, as assumed, the family relationship is harmonious, the consummation of this transaction will not be detrimental to the taxpayer since it will result in a tax benefit. In view of the fact that estate tax rates substantially exceed those of the gift tax, the *inter vivos* transfer would represent good estate planning. Moreover, the disposi-

tion of one's estate by gift as well as devise will exempt the maximum amount from both forms of taxes and subject the residue to minimum tax rates.

Hence, based upon the foregoing assumption, it would appear that the failure of the plan would result in no loss whereas its success would achieve considerable tax savings.

Corporate Liquidation

Reg. 111, Sec. 29.115-9 provides another method of avoiding the impact of Section 115(g), as follows:

> "If a distribution is made pursuant to a corporate resolution reciting that the distribution is made in liquidation of the corporation, and the corporation is completely liquidated within one year after the distribution, the distribution will not be considered essentially equivalent to the distribution of a taxable dividend, . . ."

By this provision, the existing sole stockholder may dissolve the corporation and transfer the assets in liquidation to himself. Under this alternative the capital gains tax will be imposed upon the excess of the value of the distributed assets over the basis of the stock in the hands of the taxpayer. However, the operation of a business as an individual proprietorship would subject the business net income to maximum tax rates. To avoid this situation, gifts of stock to the taxpayer's spouse and issue may be made previous to the dissolution of the corporation. Or, if preferred, partnership interests may be gifted to the former stockholder's wife and son subsequent to liquidation. Limited liability, to a certain extent, may be obtained for the successor business by the formation of a limited partnership rather than a general partnership.

Presently, corporate liquidation may be advisable even without the additional motivation of section 115(g). As stated previously, double taxation has always been an inherent evil of the corporate entity. Nevertheless, this form of enterprise has generally been more desirable, heretofore, by reason of high individual income tax rates. However, in view of the recently increased corporate taxes, the taxwise advantages of closed corporations, in many instances, have been substantially diminished, if not eliminated.

The efficacy of this final recommendation is supported by case law as well as the cited regulation. In *Langstaff* v. *Lucas,* 9 F. 2d 691, affd., CCA-6, 1926, it was held that the transfer of the assets of a dissolved corporation to its former stockholders constitutes a liquidating dividend. This rule was applied even though the corporation had but one stockholder who received all of the assets, or was owned by one family.—*Benjamin H. Read,* 6 B.T.A. 407; *Romie C. Jacks,* 19 B.T.A. 559. This rule was also applied where the corporation was succeeded by a partnership composed of the former stockholders, even though there was no actual distribution, but the account of each stockholder was credited with his share on the books of the partnership. *Jos. J. Gravley,* 44 B.T.A. 722. The effect would be the same if the transfer were to a limited partnership. *Estate of D. F. Buchmiller,* 1 B.T.A. 380.

Conclusion

The pertinent regulations and the related cases stress the fact that the question whether a redemption will be treated as being essentially equivalent to a dividend distribution will depend upon the circumstances of each case. Hence, it would be wise to obtain the prior approval of the Commissioner before initiating a redemption.

In the event that the application is disapproved, the taxpayer will nevertheless profit from the feature of estate planning. On the other hand, if the application is approved, or it is decided to liquidate the corporation, the tax savings stemming from the conversion of ordinary income to capital gains would be considerable.

In effect, therefore, the foregoing recommendations should generally benefit the taxpayer irrespective of their success or failure.

How to Hold Your Own

(Tax Planning for an Estate)

By MIRIAM I. R. EOLIS, C.P.A.

Estate Planning in these days of high taxation can, with some thought, preserve large portions of estates which might otherwise be quickly dissipated by taxation. This paper deals with some readily available techniques designed to effect a minimization of estate and income taxes.

To afford maximum conservation from omnivorous taxation in estate planning, it is wise to begin property dispositions during testator's lifetime. It is possible through carefully distributed generosity to disgorge fabulous estates without paying tribute to the tax collector.

Inter-Vivos Family Gifts

Annual Exclusions

First, consideration should be given to the annual gift tax exclusion. A donor with sixty thousand dollars bursting his purse strings, and a family of five children and fifteen grandchildren all ready to be the recipients of his Machiavellian beneficence, can succeed in distributing that tidy sum among his descendents without even filing a gift tax return. The law says he may distribute in any calendar year up to three thousand dollars each to as many donees as he and his pocket see fit, without informing the government of his generous impulses. Moreover, he may continue to do that each year for as many years as he is so urged to do. Thus, over a period of ten years, a man in the position of our donor could comfortably dispose of half a million dollars with no tax involvements.

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Lump-Sum Exemption

Should our donor's generosity achieve even greater heights, he might, by availing himself of a lifetime gift tax exemption, separate himself from an additional sixty thousand dollars without tax tribute. The gift tax law provides that after the exclusion of three thousand dollars per annum to each donee, a donor may distribute over his lifetime an additional sixty thousand dollars. However, he must inform the tax collector of this phase of his beneficence by filing a return in each year that he makes such gifts.

Marital Deduction

The 1948 Revenue Act introduced a new concept in gift and estate tax law, namely the concept of the marital deduction. At this point we shall confine ourselves to its application to gifts. The law differentiates gifts made to

a spouse and gifts made to a third party. In order to ensure the deduction, the marital status must obtain at the date of making the gift. It need not exist at the date of filing the return. Marital status which does not exist at the time of making the gift cannot be perfected by a subsequent marriage within the same calendar year. Furthermore, if the marriage is dissolved by death or divorce, remarriage before the end of the year will make the marital deduction unavailable.

In the case where a gift is made to a spouse, the donor must be a resident or citizen, the donee need not be. The deduction may be taken to the extent of one-half value of the gift before considering the exclusion. For example, if a husband makes a gift to his wife of ten thousand dollars, he must file a return showing a gift of ten thousand dollars, a marital deduction of five thousand dollars, leaving a balance of five thousand dollars, which is then reduced by an exclusion of three thousand dollars. The taxable balance is then two thousand dollars.

In the case of gifts made to a third party, the concept of the marital deduction permits the donor and his spouse to treat any gift as made one-half by each. This results in doubling the exclusions and exemptions. However, in these situations, written consents must be given by the other spouse to permit a donor spouse to avail himself of the deduction. The consent must be filed before March 15th of the year succeeding the making of the gift. If no return is filed by that time, consent may be signified any time before filing or before a deficiency is assessed. Furthermore, a consent filed before March 15th may be revoked prior to that date. In the case of gifts made to a third party both spouses must be residents or citizens at the time of making the gift.

Returns and Incidence of Tax

A donor must file a return and a consent if any gift he makes is over three thousand dollars. Both spouses must file returns and consents if any gift is over six thousand dollars. A consent filed in any year does not control an election for any other year.

A problem arises concerning the right of an executor to give a consent on behalf of a decedent. For example, a wife makes a gift to a third party during the year, and it is understood that she will utilize the marital deduction. Before the end of the year the husband dies. When the wife files her gift tax return the following March 15th, she tries to obtain consent from the executor to afford her a marital deduction on her gift tax return. The executor's authority to give such consent may well be questioned. However, incorporating a clause in the will authorizing the executor to give such consent, provides a feasible solution. An important factor in determining whether consent for the marital deduction should be given, is the factor of joint and several liability for the gift tax for that year.

It should be borne in mind that when one spouse pays the total gift tax for both, no gift tax results by reason of the payment of the liability of the other spouse.

Inter Vivos Charitable Gifts

Another method of disposing of a portion of an estate during lifetime is through the medium of contributions to charitable organizations. Certain restrictions must be met in this regard.

There is the over-all limitation on such gifts restricting them to fifteen per cent of donor's adjusted gross income for any taxable year. The gifts must be made to recognized charitable organizations in order to obtain the deduction.

In the case of a donor who desires to avail himself of his fifteen per cent limitation regularly, it may be wise to consider the advisability of organizing a recognized charitable foundation. Then, as he approaches the end of his

calendar year, instead of making a desperate effort to corral his charities in a haphazard kind of way, he may make one contribution to the foundation which then has the opportunity of carefully studying the demands made upon it before distributing its beneficence.

Charitable gifts made in kind frequently succeed in saving heavy income taxes, and sometimes in unloading white elephants profitably. A donor who makes a gift of some asset which has a low cost and high market value, pays no tax on the appreciation in value, and gets a deduction for the full market value for income tax purposes. Owners of large estates have turned them over to the government as museums and parks, and obtained valuable tax deductions therefrom.

Testamentary Dispositions

After proper attention has been given to lifetime dispositions of property, a testator still has many avenues of approach left to him to conserve his estate from too great ravages of taxation by planned testamentary dispositions. Without proper planning serious hardship may result in an estate of even vast proportions.

Minimizing Income Taxes

Taxation of Estate in Process of Administration

Let us first consider in what way proper planning can minimize income tax problems arising out of estates. Income taxes arising out of an estate attach first to the estate itself while it is in process of administration, to various testamentary trusts, and to legatees. The income taxes of the estate while in process of administration may be minimized by giving the executor considerable latitude in when and how to make distributions to legatees. Thus, if there are many legatees in low income tax brackets and the income of the estate is high, the executor may make distribution of the income to the legatees where the income tax will be more lightly felt. On the other hand if there are only one or two legatees in a high tax bracket entitled to the income, it may be wiser for the estate to retain the income and prolong the administration as long as possible, and thus maintain an additional tax entity and exemption.

Separate Testamentary Trusts

Creating separate testamentary trusts helps to defeat an inordinately high income tax. Thus, a testator who creates one testamentary trust with many beneficiaries leaves after him a much higher income tax liability than a testator who creates a separate trust for each of his beneficiaries. Of course, many trusts, rather than one, create more trustees, more commissions, more legal and accounting fees, more expense, but the tax savings generally far outweigh the additional cost.

Distributions in Kind

Another method of minimizing income taxes is to make testamentary distributions in kind. For example a testator leaves his son one hundred shares of American Telephone and Telegraph Co., Inc. When the testator dies, the shares are valued at one hundred forty dollars each. When they are distributed to the son they sell for one hundred sixty dollars. No income tax is paid on the appreciation. On the other hand, if the testator had left his son a cash legacy of one hundred fifty thousand dollars, and it was necessary for the estate to sell the American Telephone and Telegraph Co., Inc., stock to obtain the funds to pay the legacy, the estate would have to pay an income tax on the twenty thousand dollars appreciation. Distributions in kind to charities of art collections, stamp collections, etc., rather than bequests of money, eliminate a similar income tax problem in that no tax is paid on appreciation in value.

Joint Income Tax Return for Decedent and Surviving Spouse

An income tax saving is frequently obtained by the filing of a joint income tax return by a surviving spouse with the decedent. However, the executor of the decedent's estate must consent to such filing, and frequently questions his authority to do so because of the joint and several liability which attaches to a joint return. What is even more significant is the question of the estate's responsibility for paying the tax, as well as the method to be used for apportioning the tax between the surviving spouse and the estate, if there is to be apportionment. Should the tax be apportioned in the ratio of the two incomes? Or should the tax be computed on the survivor's income, then on the joint income, and should the difference be charged to the estate. Or should the tax be computed first on the decedent's income, then on the joint income, and should the difference be charged to the survivor? Or should the estate pay the tax on the joint income? It might in many instances be much to the estate's benefit, to file a joint return and pay the total tax, rather than file separately. For example, if the decedent had income of fifty thousand dollars and the surviving spouse had income of one thousand dollars, the joint liability would be approximately twenty-two thousand dollars, whereas, if separate returns were filed by the decedent's estate and the surviving spouse, the tax would be respectively, approximately twenty-seven thousand dollars and one hundred dollars. The question would arise, may the executor take the authority to file jointly and pay the full tax, or must he apportion, and by what method. The simplest solution to what may indeed become a formidable problem is to make provision in the will authorizing the executor in his discretion to file a final joint income tax return and to pay as much of the tax liability as he deems feasible.

Minimizing Estate Taxes

Marital Deduction

Proper estate planning in regard to testamentary dispostions may well result in greatly minimized estate taxes. The marital deduction has revolutionized this phase of estate planning. Utilization of the full deduction has become a tricky challenge in will drafting as well as in tax planning. Under the Revenue Act of 1948, estates are entitled to a marital deduction up to fifty per cent of the adjusted gross estate. The adjusted gross estate consists of the gross estate less deductions for funeral expenses, administration expenses, claims, mortgages, etc. To arrive at "adjusted gross estate" no reduction is made for the specific exemption, previously taxed property or charitable bequests. The value of the interest passing to the surviving spouse is the value listed in the estate tax return. In determining the value of the interest passing, there must be taken into account the effect the estate tax has on the net value to the surviving spouse. Thus, if the decedent leaves his wife fifty per cent of the estate, and her portion must bear a proportionate estate tax under local law, she will actually receive less than fifty per cent of the adjusted gross estate, and the marital deduction will be similarly reduced. For example, let us assume decedent leaves a gross estate of two hundred and twenty-five thousand dollars. The adjusted gross estate is two hundred thousand dollars. The widow is left fifty per cent of the estate. Let us further assume the total estate tax is twenty thousand dollars, and the widow's share of the estate tax is then ten thousand dollars. The widow will receive one hundred thousand dollars as her share against which she will pay ten thousand dollars in estate taxes. The value of her share will be ninety thousand dollars. That will also be the amount of the marital deduction. If properly planned however, the estate could be entitled to a marital deduction

of one hundred thousand dollars. Under this kind of a bequest, it also becomes necessary to compute algebraically the marital deduction and the estate tax, and while the problem is far from insurmountable, it can easily be avoided. In general, it is desirable to provide by will that the estate be divided into two portions, a marital portion and a non-marital portion; the marital portion should pass free of estate taxes, and the non-marital portion should be burdened with the estate tax. If the maximum marital deduction is desired, it can be obtained through such an approach because the maximum marital deduction is based upon adjusted gross estate which in turn is determined before deduction is taken for estate taxes.

Charitable Gifts

Testamentary dispositions to charities result in a deduction to the estate for computation of the estate tax. The deduction is allowed for property transferred to the government, a state or territory for public purposes, or to any charitable organization, or to any fraternal organization which uses the gift for religious or charitable purposes. The amount of the deduction may in no event exceed the value of the transferred property required to be included in the return. Furthermore, if estate taxes are payable out of the charitable bequest, the amount of the deduction must be reduced by the amount of such taxes. Thus, it may become necessary to develop an algebraic formula to arrive at the estate tax dependent upon the amount of the charitable deduction, and the charitable deduction dependent upon the amount of the estate tax. In a few states the charitable bequest does not bear a proportionate share of the estate tax, and therefore, no reduction is required to compute the net charitable bequest. However, where the local law burdens the charity with tax, the need for involved algebraic formulas can be avoided by having the will provide that the charity is to be relieved of its estate tax burden, if that is otherwise desirable for the testator.

Charitable Foundations

Charitable foundations are a useful device in obtaining a charitable deduction and simultaneously developing favorite charitable causes. They help to obtain an immediate deduction on distribution to the foundation, with a subsequent disbursement of the funds by the foundation. However, they serve a much more useful purpose in affording a certain liquidity to estates for the payment of estate taxes and for retention of family control of business organizations. Frequently it occurs that the main asset of an estate turns out to be stock in a closely held corporation of which decedent is the principal stockholder. Frequently there is not sufficient cash to pay the estate taxes resulting from the high valuation of the stock. The executors have the alternatives of selling the stock in the open market, if there is one, and thus losing control of the business, or of retaining some or all of the stock of the corporation, and thus relinquishing part or all of the control of the business. A method of disposing of the stock and still retaining control has been evolved by means of the faimly foundation. The stock may be left to the foundation as a charitable bequest thus affording the estate a deduction for the value of the stock. Now since the foundation is the principal stockholder, the family which controls the foundation can control the policies of the corporation. While it is true that dividends now accrue to the foundation, officers' salaries and directors' fees are controlled in both the foundation and the corporation. Thus, both liquidity of the estate and control of the family business may be maintained by means of the foundation.

In making contributions, it is generally desirable to donate non-liquid assets and retain the liquid ones in the estate to facilitate payment of taxes,

expenses, and cash legacies. Where there is a serious dispute over the valuation of certain assets, those are the ones which should be favored for charitable bequests.

Relief Under I.R.C. § 115(g)(3)

One of the greatest problems of most of the present day estates is the maintenance of liquidity to meet the impact of heavy estate taxes. Where foundations are not used as a palliative, and stock holdings are the principal asset of the estate, part of the stock is frequently redeemed to pay the taxes. However, where such redemptions are considered dividends, the income tax may well absorb most of the estate. In the 1950 Revenue Act, relief therefore was afforded estates under Section 115(g)(3) of the Internal Revenue Code. Under this section distributions in cancellation or redemption of stock to pay death taxes are not taxed as a dividend where the value of the stock in the gross estate is in excess of thirty-five per cent of the gross estate. The section applies to distributions made after October 20, 1951. In the case of distributions after September 23, 1950, and before October 20, 1951, the applicable percentage was fifty per cent of the net estate. The executor or distributee may surrender for redemption, stock in the corporation sufficient to pay that portion of the tax allocable to the distributee entitled to the stock. The cost basis for determining gain or loss on redemption is the date-of-death value, not the decedent's original cost. The redemption must be made within three years and ninety days from the date of filing of the return.

The thirty-five per cent limitation while a relief provision does not go far enough. It works hardships in many estates without reason. For example, unexpected inclusions in estates may disqualify an estate for relief. Gifts held to be in contemplation of death, marked variations in valuations, and remote reversionary interests may make it almost impossible for a testator to plan liquidity of his estate. Hardship may be worked also in a situation where decedent has holdings in many different corporations because of the peculiar nature of his business. For example, the principal owner of a chain-store outfit which has a separate corporation for each store might have twenty corporations all related, but no one of which comprises thirty-five per cent of the gross estate. The statute was never intended to penalize such situations. Little revenue would actually be lost if the percentage limitation were completely eliminated, and certainly greater equity would be achieved.

Although Section 115(g)(3) has been in effect since 1950, no conforming regulations have been promulgated. A few weeks ago however, regulations were finally proposed. The regulations indicate that the applicable percentage applies to all the stock both common and preferred held in any one corporation. For example, if decedent owned one hundred thousand dollars of common stock and fifty thousand dollars of preferred stock in the same corporation, and left a total gross estate of three hundred thousand dollars, 115(g)(3) would apply because the ratio of one hundred fifty thousand dollars to three hundred thousand would be in excess of thirty-five per cent.

Where the decedent leaves stock of his corporation to his son, and other assets to his daughter, stock in the corporation may be redeemed under 115(g)(3) only to the extent of the tax applicable to the son's portion of the estate. If, on the other hand, the stock is left to the son and the will provides that taxes are to be paid out of the residuary estate, no redemption is permitted under 115(g)(3).

Where decedent leaves stock and other assets, and gives the executor discretion as to the method of distributing the estate among the beneficiaries, the proposed regulations provide that the redemption is allocable among the beneficiaries regardless of how the executor actually distributes. In the light of

these regulations it would seem wise to prepare wills so as to give the executor such discretion.

With the passage of Section 115(g)(3) many tax advisors perceived the desirability of issuing tax-free preferred stock dividends, and using the preferred stock for redemption. Thus, it became possible to maintain the control of the corporation in the estate's hands while still providing some liquid assets. Under the Supreme Court decision of *Emil H. Strassburger,* (318 U.S. 604) such a stock dividend was held tax free where the relative positions of the stockholders were the same after the stock dividend as before. However, a few weeks ago a bombshell decision was handed down by the Tax Court in the *C. P. Chamberlin* case (18 T. C. 23) holding a preferred stock dividend taxable. The *Chamberlin* case was one where the corporation had a substantial surplus, cash and bonds. It was in serious danger of a Section 102 surtax. It made no distribution of dividends. The corporation contacted an insurance company which agreed to buy eight hundred thousand dollars of preferred stock from the stockholders when and if issued. The corporation then issued a common stock dividend of five hundred thousand dollars, and immediately after, a preferred stock dividend of eight hundred thousand dollars to common stockholders. The stockholders immediately sold their stock to the insurance company. The Commissioner did not attack the common stock dividend but held the preferred stock dividend ordinary income. The taxpayers claimed the dividend was non-taxable in line with the *Strassburger* case. The Tax Court held this was not a true stock dividend but merely a device to get cash into the hands of stockholders. The case will in all likelihood go to the Supreme Court. In the meantime, beware of such transactions.

Need For Periodic Review of Plans

All estate planning, in the light of rapidly changing decisions and statutory changes, must be frequently and carefully reviewed. Such planning should be made with the customary reminder to the testator of "the uncertainty of life and the certainty of death;" and then a wise tax advisor will acquaint the testator with the relative certainty of taxes and the equally relative uncertainty of how much.

SYMBOL OF SERVICE

Federal Tax Commentaries

By Edward T. Roehner, C.P.A.

We present to our readers this new feature—some critical thinking on current tax problems by a well-qualified commentator.

115(g) Redemption of All the Stock of a Shareholder

We have found that accountants are troubled by what they consider the possibility that a stockholder who sells all his shares to the corporation may be taxed on his pro-rata share of the accumulated earnings or profits. A recent District Court case appears to lend support to this fear, but, we believe, only because it was not properly argued. (*Fern R. Zenz* v. *Quinlavan, Collector,* USDC, Ohio, June 27, 1952.)

In our opinion, the case was lost only because the stockholder was unaware of the rule laid down in *Helvering* v. *R. J. Reynolds Tobacco Co.,* 306 U.S. 110 (1939) and allied cases, which hold that if a section of the tax statute is repeatedly reenacted after a regulation has interpreted the section the regulation acquires the force of law. The regulation interpreting 115(g) provided, as early as 1928, that the redemption by a corporation of all the stock of a particular stockholder is not equivalent to the distribution of a taxable dividend.

The taxpayer quoted the regulations, but, instead of arguing the *Reynolds* case, argued early cases which held that if a corporation by a distribution of capital stock capitalizes earned surplus for a good business reason the subsequent redemption of the stock is not equivalent to the distribution of a taxable dividend. The trial court determined that these cases were no longer good law, and decided against the taxpayer.

Even the amendment to the regulation now proposed by the Commissioner provides only that, if the family of the stockholder whose stock is redeemed continues to own stock in the corporation, that continued ownership is a factor to be considered in determining whether the redemption is equivalent to the distribution of a taxable dividend.

For those who are interested in a further discussion of the case, the facts were that a widow who owned all the shares of a general contracting company, most of which she had inherited from her husband, agreed in an arm's length transaction with a partnership in the same business, in which she had no interest, to sell them 47 of the shares at $790 a share. Nineteen days later she sold the remaining 61 shares to the corporation, the officers and directors of which were the purchasers of the 47 shares, who had already taken office. The price was also $790 a share, and was approximately the amount of the earned surplus. The court found that the mechanics had been arranged by the attorney for the purchasers, whose clients would accept nothing less than complete ownership of the corporation, but did not want all the assets.

The Commissioner argued that the "net effect" of the transaction was to give her the earned surplus. The cases cited by the Commissioner as supporting the net effect theory were cases in which the taxpayer was left with the

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same, or almost the same, proportion of stock ownership as before the redemption, and have no relevance to the facts in this case. The taxpayer cited cases which had been overruled and did not controvert the cases cited by the Commissioner. The District Court therefore decided in favor of the Commissioner.

Had the taxpayer argued her case in the Tax Court she would have won, for that sophisticated Tax Court would have decided the case on the law as the court knew it, not on the arguments alone.

We believe that the decision has been misunderstood in Washington, and has created a good deal of unnecessary excitement. Washington does not seem to realize that the decision was obviously based solely on the arguments presented.

One tax letter to accountants says that talks with top officials in the Bureau indicate that the Bureau will exempt from tax as a dividend any redemption of all the stock of one shareholder, *if he ceases to retain any control over the corporate policies.* They illustrate by giving the case of a majority stockholder who sells out to the junior stockholders, with payments to be made over a ten-year period. If he is asked as part of the deal to stay on as president and chairman of the board, with the ability to control top policy decisions, the Treasury would probably claim a dividend. To us the Treasury position is one that can be dismissed without fear, but taxpayers should take such cases to the Tax Court, which is more sophisticated in such matters than is the average District Court.

In a subsequent issue, the tax letter said that the interpretative branch of the Treasury in Washington was surprised at the decision, and that right up to the time of the decision it had been issuing informal rulings that there was no dividend in transactions like the one attacked in the District Court; but that now the Treasury is of a different mind, that no rulings will issue, and that the agents in the field will be more likely to attack all stock redemptions.

The letter continues that *for the moment* stock redemptions of all the stock of a stockholder still seem to be in the clear where the other stock in the corporation is not owned by members of the family. But, as we pointed out, until the Commissioner *actually* changes the regulations, the *Reynolds* case, which nobody refers to, safeguards the taxpayer, and consummated transactions are not affected by the change in the regulations.

We will seize this opportunity to correct another error on 115(g). The Tax Clinic of the Journal of Accountancy for October, 1950, as a warning to accountants devoted more than a column to quoting from an article by Professor Joseph Hawley Murphy, of Syracuse Law School, in which he says that under the famous *Bazley* case if the retiring stockholder receives part of his consideration in notes or bonds he may be taxable under section 115(g). Since the Tax Clinic publishes corrections of material appearing in its columns (see the correction by Benjamin Grund in the June, 1952, issue) we assume that the absence of any correction means that the warning has been accepted as correct. However, Professor Murphy misread the *Bazley* case. He quotes language from the Supreme Court opinion which is alleged to state that if corporate obligations are distributed to stockholders in *exchange* for their former stock holdings the obligations are not immune from tax because cast in the form of a recapitalization. What the Supreme Court said was that if, in a recapitalization, corporate obligations are distributed to stockholders *in relation to* their stock (the same proportion of stock being retained at a lower par value) the bonds are taxable under 115(g).

Joint Returns that the Wife Does Not Sign

In *W. K. Kann and Stella H. Kann*, 18 T. C. #131, promulgated September 18, 1952, the Tax Court held that income tax returns designated joint returns but signed only by the husband will, in the absence of contrary evidence, impose liability upon the wife for deficiences and fraud charges.

We believe that this decision is unsound. There was no finding of fact that the wife was required to file a return by reason of her gross income or that she had any deductions which reduced her husband's tax, or that she had authorized the filing of a joint return.

The headnote, which was prepared by the court, stated that *Myrna S. Howell*, 10 T. C. 859, affirmed 175 F 2d 240 (CA-6, 1949) was being followed, but that case is not in point. In the *Howell* case the Tax Court found as a fact that the wife had income and deductions and had not filed a separate return. The wife did not appeal that question to the Circuit Court of Appeals, and therefore the statement in the headnote that the Circuit Court affirmed is misleading.

The Tax Court said that there is a presumption that the Commissioner's determination of a deficiency is correct. However, the presumption does not seem to apply to the present case, where it is without rational foundation. The court said that it had held in *Joseph Carroro*, 29 B.T.A. 646, 650, that where a husband files a joint return without objection by the wife, who failed to file a separate return, it will be presumed that the joint return was filed with the tacit consent of the wife. The *Carroro* case is not in point, for in that case the wife's admitted income required her to file a return. Moreover, even if the presumption applied to the deficiency, it does not apply to the fraud penalty, which was also imposed. The Tax Court has repeatedly held that the burden of proof as to the fraud penalty is on the Commissioner, and where the only evidence against the taxpayer, as here, was the presumption, it has found for the Commissioner on the deficiency and for the taxpayer on the fraud issue.

Deductions as Omissions from Gross Income

If the amount of gross income a taxpayer omits from his return exceeds 25% of the gross income reported, the statute of limitations is five years, not three. One tax letter to accountants, discussing the *Uptegrove* case (TC Memo, decided July 15, 1952) says that "the Tax Court has reaffirmed that this isn't limited to omission of income. An *overstatement* of deductions has the same effect as omitting income for this purpose." This is not correct. The taxpayer deducted the amount in question, which consisted of salaries and wages, from gross sales as part of the cost of goods sold, which meant that the amount was an omission from gross income, since gross sales less cost of goods sold gives gross profit from sales, which is part of gross income.

They also say that the Tax Court implied in this case that if the amount had been deducted from gross income it would not have been considered an omission from gross income, but they warn that in the *Marvin Berry* case (TC Memo, April 3, 1952) "an overstatement of general expenses brought the extended statute into effect." That is incorrect. In the *Berry* case, the taxpayer, who resided in a community property state, allocated half of his gross income to his wife, but, since he was not married until August 30th, he was entitled to allocate only one-half of the remaining four months of the year to her, or one-sixth. The excess allocation was considered an omission from gross income.

The court also said, "There is another facet to this question which presents a further reason for sustaining respondent's position in regard to this issue." It then pointed out that no gross income was reported on the face of the

(Continued on page 695)

Written Representations to Auditors

By ELI PHILLIPS

After reviewing the types of written representations customarily obtained as well as the reasons for securing them, the author seeks to ascertain the justification for this procedure. Next, he examines into the attitudes of private and governmental agencies charged with certain regulatory functions with respect to financial statements. He then reviews pertinent court decisions and certain analogous situations. Upon the basis of all this he reaches certain specific conclusions as to written representations received from clients and from third parties.

THE accounting profession accepts, practically without question, the practice of procuring many and varied written representations from clients and third parties when making independent audits. Accounting texts, pronouncements of the American Institute of Accountants, accounting journals—all, in one form or another, advocate this procedure or, at least, say that it is generally used and accepted as proper and useful.

Why are these written representations requested by auditors? What matters do they cover? What is their value? Should they be gotten? Why?

Before answering these questions, it is necessary that we define our terms.

Written representations (sometimes called certificates) are signed statements attesting to the accuracy of information given to the auditor by the client and third parties. The client, of course, is the individual, partnership or corporation whose books are being audited by an independent auditor retained by the examinee for that purpose. Third parties, as the term is used herein, are persons (individual or corporate) who, by reason of some business relationship with the client, are in possession of first-hand information concerning some aspect of the client's business.

ELI PHILLIPS, an attorney-at-law, just completed (June, 1952) the course of study leading to the degree of Master of Business Administration, with a major in Accountancy, at The City College (N.Y.) School of Business and Civic Administration. He had previously earned the degrees of B.S.S. and LL.B.

Mr. Phillips' paper was awarded the first prize in the 1951-1952 prize essay contest conducted by the Society.

Types of Written Representations Customarily Obtained

Now, what types of representations are customarily obtained? Taking up first those from the client, we find but little uniformity in the practice of the profession. It is, though, generally accepted that a representation should be obtained as to inventory. Most auditors also require one covering unrecorded liabilities—some additionally insist that it cover all liabilities. Many auditors request representations as to receivables. Some obtain them for fixed assets. Others want a written statement as to the status of the corporate books. A few large firms require a comprehensive representation covering practically all items on the balance sheet.

With respect to representations from third parties, the practice is somewhat more consistent, even though not completely uniform. Direct confirmation of

notes and accounts receivable is now considered a "must" where practicable and reasonable. All auditors require a bank certificate as to funds on deposit and other transactions between client and bank. Direct confirmation of notes payable is an accepted procedure. Mortgages receivable are usually confirmed with the mortgagors—mortgages payable with the mortgagees. Registered bonds payable and sinking funds are generally confirmed with the trustee if there be one. Outstanding stock is confirmed with the stock registrar or transfer agent. Assets out of possession (i.e., securities out for transfer or in safe-keeping; consignments out; pledged collateral; and goods in public warehouses) are generally confirmed with the holders. Some auditors request a letter from the client's attorney as to realty titles and encumbrances, claims arising from litigation, unpaid fees and the like. Where the client has subsidiaries or foreign branches, examined by other accountants, some auditors request a comprehensive report from such other accountants; others are content to rest upon information obtained from the home office. With respect to accounts payable, there is a sharp division of opinion in the profession as to the necessity or even advisability of direct confirmation.

Reasons for Securing Written Representations

The foregoing, in bare outline, is what today's practicing accountant requires from his client and third parties in the way of written representations. Now, why does he want them? The answer to this question is found in auditing texts, bulletins of the American Institute of Accountants and articles in accounting journals, since it is from these sources that the accounting profession has acquired its body of guiding principles while at school and, later on, in active practice.

All authorities agree that procurement of an inventory certificate from the client in no way reduces the auditor's examination or lessens his responsibility. They maintain, however, that it is useful in confirming oral statements and thus avoiding misunderstandings between client and auditor; in assuring active co-operation by the client; and in reminding the client of his primary responsibility for the correctness of his records and financial statements.

Similarly do all concur in the view that the client's liability certificate is not a substitute for a proper examination and in no way decreases the scope of the audit. But, they say, since the audit of liabilities is directed primarily at the discovery of liabilities not shown on the balance sheet, procurement of a liability certificate is a valuable part of the required search for such undisclosed liabilities.

The rationale for procurement of the client's representations as to receivables and fixed assets is the same as that noted for inventory certificates. Procurement of a comprehensive representation, covering both assets and liabilities, would be explained by the same reasons plus those stated for the liability certificate.

Turning to representations from third parties, we find bank certificates considered the most reliable evidence as to the client's cash balance, since it comes from an independent, impartial person with knowledge of the facts. This representation is also believed useful in the search for undisclosed liabilities. Confirmations of notes and accounts receivable are similarly believed to be the best evidence of the accuracy and authenticity of those accounts. They are also thought valuable in uncovering fraud, detecting errors and testing internal control. Confirmation of assets out of possession is held useful in establishing existence and ownership. However, where the amounts are significant, auditors are cautioned to check the *bona fides* and financial responsibility of the custodians. Letters from attorneys as to

suits, claims, unpaid fees, realty titles and other legal matters are believed to be a valuable part of the search for undisclosed liabilities and a reliable source for such information. Letters or certificates from appraisers and architects, though not conclusive, are considered useful supporting evidence. With respect to confirmations of accounts payable, those in favor maintain that the procedure is not too burdensome and is a good test of internal control and the correctness of the client's records. Those who oppose its general use, however, believe it is valueless in the unearthing of unrecorded liabilities unless done so completely as to make the cost prohibitive. Moreover, say they, the same results can be accomplished by other procedures which are more practicable.

Is the Procedure Justified?

All these, then, are the representations now generally obtained and the reasons given for their procurement. The next question is—Is this procedure justified? A definitive answer is best sought in decisions of the courts and in the rulings and practice of governmental and private bodies charged with the task of making, interpreting and applying laws and regulations pertaining to fields in which accounting plays a part. Accordingly, letters of inquiry were sent to representative governmental and private agencies and their regulations, rulings and published literature were carefully examined. In addition, an exhaustive search was made for court decisions, statutes and articles in legal periodicals which might throw light on this problem.

Attitudes of Private and Governmental Agencies

The attitude of private and governmental agencies will be discussed first, with each treated separately for the sake of clarity.

The New York Stock Exchange: The New York Stock Exchange has definite regulations concerning the scope of the required audit of member firms. Rule 532 requires many and varied written confirmations from third parties including, *inter alia*, confirmations of bank balances, loans payable, securities borrowed and loaned, customers' accounts and securities in transit. It also requires written representations from the officers and partners of the examinee as to their own accounts and, additionally, as to unrecorded assets, liabilities and accountabilities. With respect to audits of listed corporations, the Exchange has neither fixed requirements nor specific attitude towards written representations, its position being simply that the audits must comply with accepted standards of the accounting profession.

The New York Curb Exchange: The regulations and attitude of the New York Curb Exchange are identical with those of the Stock Exchange.

The New York Credit and Financial Management Association: The New York Credit and Financial Management Association (an organization of credit men) prefers that audits made for credit purposes include written confirmations from third parties of at least the following—bank balances, notes and accounts receivable, notes, loans and accounts payable. With respect to written representations from the client, it does not specifically express any opinion or preference one way or the other. However, from its pervasive concern that all liabilities be disclosed, one may reasonably infer a desire that the auditor obtain from the examinee a representation as to unrecorded liabilities—not as a statement upon which the auditor may rely conclusively, but rather as one of many useful procedures in the search for undisclosed liabilities.

The Public Service Commission: The Public Service Commission's field auditors do not ordinarily obtain written representations from either the examinees or third parties, except for a few minor items. However, the Com-

mission's Director of Accounting, who stresses the difference in function between the Commission's audits and those performed by public accountants, expresses a personal belief that third-party confirmations are indispensable in an audit by public accountants.

The Federal Home Loan Bank Board: The Federal Home Loan Bank Board believes that an adequate independent audit of a savings and loan association connotes the obtaining of third party confirmations as to practically all significant items that are capable of such verification. With reference to representations by the examinee, however, the Board apparently attaches importance to only two—a letter from the secretary attesting to the completeness of the association's minutes and a representation from the officers as to unrecorded liabilities. One may also infer that the Board believes an auditor is entitled to rely upon written expert opinions from qualified appraisers as to value and from attorneys as to title, claims, suits and similar matters.

The Federal Reserve Board: The only published expression of the views of the Federal Reserve Board (issued in 1929) similarly stated that a satisfactory audit should include third-party confirmations of bank balances, notes and accounts receivable, securities out of possession, notes payable discounted, bonds and mortgages payable and the client's capital stock. In addition, said the Board, the auditor may obtain a written representation from an attorney or title company as to mortgage liens and judgments. The Board also advised that the auditor obtain an inventory certificate and an undisclosed liabilities certificate from the client. However, it should be noted that this view was expressed in 1929—long before the *McKesson & Robbins* case and the publication of "Extensions of Auditing Procedures"—and it is at least questionable whether the Board would today advocate procurement of inventory certificates.

The Interstate Commerce Commission: The Interstate Commerce Commission requires transportation companies under its jurisdiction to file annual reports accompanied by a short-form comprehensive representation by management as to the report's accuracy. The basis for this procedure is two-fold. First, the Commission's own auditing staff is so small that extensive audits are possible only in unusual cases. Second, the relationship between Commission and reporting company is radically different from that between independent auditor and client, since the reporting company is a licensee dependent upon the Commission for its very existence and, in addition, its officers may be subjected to severe criminal penalties in case of falsification or fraud. It is interesting to note though that, despite procurement of this representation, the Commission's auditors, when making an audit, test-check most items and accept only a bank certificate as conclusive.

The Securities and Exchange Commission: The Securities and Exchange Commission has no fixed rules as to audit procedures, except for Rule X-17A-5 which, dealing with stockbrokers, is identical with Stock Exchange Rule 532. There have, though, been some decisions indicating the Commission's general attitude as to reliance upon representations. In the *McKesson & Robbins* case, the Commission strongly advocated an extension of the procedures of physical inspection and independent confirmation, particularly with respect to inventories and receivables. In the same case it also recommended that auditors be more independent of the client's management and placed upon auditors the responsibility of including management's activities within the scope of the audit. In numerous releases the Commission has ruled that an auditor is not independent where he consistently submerges his convictions as to accounting principles to the wishes of his client. Going farther, it has held audits inadequate

where auditors unquestioningly accepted management's statements and representations as to important matters. In the *McKesson & Robbins* and *Illinois Zinc Co.* cases, for example, the audits were disapproved despite the fact that inventory certificates had been obtained from management. To the same effect were the recent holdings in Accounting Series Releases 64, 67 and 68 and in the *Red Bank Oil Company* and *Tung Grove Developments* cases. With respect to confirmations from third parties, the Commission heartily approves their procurement wherever practicable and reasonable. It also appears to sanction procurement of representation letters from attorneys or title companies as to realty titles. The Securities Act of 1933, by implication, authorizes an auditor to rely upon a representation by a third-party expert where the auditor has no reasonable grounds to believe and does not in fact believe it untrue. And the situation is the same with respect to official documents and statements by official persons. With regard to other accountants' reports on subsidiaries or branches, the Commission seems to bar reliance unless the certifying accountant either files the other accountant's certificate or else himself assumes full responsibility for the other accountant's examination. Finally, the Securities Act places upon an auditor the responsibility of making such reasonable investigation as will support a reasonable belief in the truth of the financial statement, except where the items are based upon statements of a third-party expert or official person, and reliance upon a client's representation must be evaluated in the light of that responsibility.

Attitude of the Courts

Let us now see what the courts have said on this subject. A good starting point is English law since our American law there has its roots.

English cases: In *Leeds Estate* v. *Shepherd,* L.R. (1887) 36 Ch. Div. 787, an auditor's acceptance, without investigation, of management's statements as to adequacy of security for loans was disapproved on the ground that it did not fulfill the auditor's duty as outlined in the company's articles of association. *In Re London & General Bank,* L.R. (1895) 2 Ch. Div. 673 stated, *inter alia,* that an auditor may rely upon the opinion of an expert where special knowledge is required. In the case of *Kingston Cotton Mill Company,* L.R. (1896) 2 Ch. Div. 279, an auditor's reliance upon the manager's inventory certificate was held justified where the manager was a trusted, ostensibly honest employee and there were no suspicious circumstances. This rule, though, has been "whittled down" by later English cases and in our country the trend has clearly been towards the requirement of a higher standard of care. For example, in *Mead* v. *Ball, Baker,* 106 L.T. Rep. (N.S.) 197, the trial court applied the *Kingston Cotton Mill* doctrine but, on appeal, the higher court deliberately side-stepped the question of whether an auditor's duty with respect to inventory certificates might not be greater where he is employed by one other than the examinee. In *Fox* v. *Morrish, Grant,* 35 T.L. Rep. 126, the court inferentially approved reliance upon a bank certificate as verification of cash in bank. The case of *City Equitable Fire Insurance Co.,* 94 L.J. Rep. (N.S.) 445, contained interesting but inconclusive discussions by a split appellate bench concerning an auditor's right to rely upon a certificate given by one holding securities for the examinee. The very recent English case, *Candler* v. *Crane, Christmas,* 67 Law Quarterly Review 466, contained dictum that an auditor was "extremely careless" when he accepted, without independent investigation, statements by the examinee's manager as to certain assets.

Canadian cases: The Canadian case of *International Laboratories* v. *Dewar,* (1933) 3 D.L.R. 665, held that where

the scope of an audit is limited because the client chooses to rely upon an ostensibly adequate system of internal control and internal audit, the independent auditor is entitled to rely upon reasonable explanations by the client's employees. Another Canadian case, *McBride's* v. *Rooke & Thomas,* (1941) 4 D.L.R. 45, aff. (1942) 3 D.L.R. 81, held that an auditor should, wherever possible, get first-hand knowledge from books and records instead of taking an employee's statements as to their contents. The same case also approved the procurement of bank certificates.

American cases: In our country, there have been a few cases outside New York State which are worth noting. In *Board of County Commissioners* v. *Allen,* 152 Kan. 164, independent auditors of county offices were found negligent for failure to check an "emergency fund" in the county engineer's office, despite the fact that they had examined vouchers which were verified and approved by the county engineer and county attorney. In *Beardsley* v. *Ernst,* 47 Ohio App. 241, auditors were held not guilty of fraud when they certified a consolidated balance sheet in reliance upon information received from a foreign subsidiary. This holding, though, was inconclusive as to whether or not such reliance might constitute negligence. In this connection, it is also pertinent to recall the previously-noted S.E.C. regulation generally barring reliance upon a foreign auditor's certificate. The decision in *Maryland Casualty Co.* v. *Cook,* 35 Fed. Supp. 160, approved the procedure of test confirmation of accounts receivable. In *United States* v. *White,* 124 F. 2d 181, an accountant was found guilty of criminal fraud where many false items in the financial statements were supported only by the uninvestigated statements of the client's officers, which the accountant accepted despite suspicious circumstances.

New York cases: Turning now to New York, we find but few reported cases involving auditors. In *Craig* v. *Anyon,* 212 A.D. 55, auditors were held guilty of negligence because they relied upon statements given to them by a trusted employee of the client, without making any independent investigation. One may also infer from this decision that the court did not deem "confirmations" of customers' accounts by the client the equivalent of an auditor's direct confirmations. In *Ultramares* v. *Touche,* 255 N.Y. 170, it appeared that, in the course of the audit, the auditors discovered substantial "errors" in the client's books, relating to overvaluation of inventory, inflation of accounts receivable and duplicated pledges of merchandise for loans. Nevertheless, they accepted and relied upon inventory and liability certificates, signed by the client's president and cashier, which subsequently proved false. The court held that, despite procurement of these certificates, a jury might properly find the auditors guilty of such gross negligence as would support an inference of fraud. In effect, then, the ruling was that the right of the auditors to rely on these certificates under all the circumstances was a question of fact for the jury. The *Ultramares* case was followed a few years later by *State Street Trust Co.* v. *Ernst,* 278 N.Y. 104. In this case, auditors procured from the client's officers a comprehensive, all-inclusive representation, in addition to a number of other representations covering specific commission accounts receivable, all of which were later discovered to be false. Here, too, as in the *Ultramares* case, they accepted and relied upon the representations without making any independent investigation, despite the existence of suspicious circumstances. Here again, even more explicitly than in the *Ultramares* case, did New York's highest court announce that it is gross negligence for an auditor to rely upon a client's written representation where the circumstances are such that they should have aroused suspicion or doubt in the mind of a reasonably prudent accountant. The case of *National*

Surety Corp. v. *Lybrand,* 256 A.D. 226, involved thefts concealed by lapping and kiting. Bank certificates had been obtained by the auditors but they covered only up to the closing date. The court's decision impliedly disapproved of such bank certificates containing data limited to the closing date of the audit and approved the practice of confirming bank transactions for a few days after the closing date.

There have been several New York cases, not involving accountants, which shed some light on the problem under discussion. *Kramer* v. *Joseph P. Day Inc.,* 26 N.Y.S. 2d 734, and *Grill* v. *Driad Const. Co.,* 34 N.Y.S. 2d 593, held that vendors of realty were not guilty of fraud in representing that the realty was free of restrictions and usable for certain types of structures, where the vendors relied upon qualified engineers, surveyors, attorneys, title companies and architects and, moreover, honestly believed the representations were true. A logical inference from these decisions would seem to be that an auditor may reasonably rely upon written representations by qualified, reputable experts as to matters within their special fields of knowledge.

Analogous Situations

The effect given representations by a typical court in its day-by-day administration of estates of its wards may also be of interest. An incompetent's estate, for example, is managed by a court-appointed guardian who must file annual accounts of his stewardship. These accounts are examined by a referee who takes the guardian's testimony under oath and then submits a report to the court. On that examination, confirmatory letters from banks, trustees and the like are usually credited by the referee and court unless some discrepancy appears which requires further investigation. Letters from attorneys as to title, litigation and interests of the incompetent in trusts or estates are similarly accepted. Generally speaking, however, statements of the guardian, even though under oath, are given little, if any, credence unless confirmed by a written statement from a disinterested third party or by a personal check-up by the Referee. And this despite the fact that most guardians are close relatives of the incompetents. Apparently, then, with respect to its own wards, the court insists upon an extremely high degree of care in the audits of the guardian's accounts. It is only fair to point out, though, that the expense of the audit is here given no consideration at all; the estates are generally small and the accounts simple; and the review by the referee is, in effect, a detailed audit verifying each item, no matter how small.

Effect of Written vs. Oral Representations

It may also be pertinent to point up one other facet of this problem. Many of the above-mentioned cases involved reliance upon oral, not written, statements. They have been included in this discussion because, in the eyes of the law, written representations generally have no greater or different significance than oral statements. With respect to the prevalent feeling among accountants that written representations are entitled to greater credence than oral statements, its source appears to be a belief that one would be loath to falsify in writing that which he might, without a qualm, falsify orally. It would seem that this feeling has, to say the least, an extremely nebulous foundation. For, in the *Ultramares, State Street Trust* and *McKesson & Robbins* cases, false certificates were given to the auditors, and in the *Kingston Cotton Mill* case the manager signed falsified inventory sheets. In the writer's opinion, an embezzler or thief will sign a false certificate as unhesitatingly as he will make an oral misrepresentation and, consequently, no greater integrity inheres in such writing than in speech.

Conclusions

Now, what conclusions can we draw as to the validity of these procedures?

First, let us restate the duty of an independent auditor so that our conclusions as to what he may or should do can be assayed against what he must do.

An independent auditor is charged with the duty of conducting a reasonably skilled, independent, impartial and sufficiently comprehensive examination of the accounting evidence to support an informed opinion as to the substantial fairness and accuracy of the examinee's financial statements.

To evaluate understandably written representations in the light of these requirements, we had best channel them into two main groups—those by the client or examinee and those by third parties. The second group can again be subdivided into opinions by independent experts and confirmations of facts shown on the client's books and records.

The Client's Written Representations

The client's written representations are most often given by the company's executive officers—in other words, by management. If the certified balance sheet is to be used to obtain credit or for filing with the S.E.C., management's interest is necessarily adverse to the interests of those who intend to place reliance upon the auditor's certificate. To a somewhat lesser extent, this is true even where the certified balance sheet is intended only for the company's stockholders. Hence, one can fairly say that written representations by management are nothing more than what the legal rules of evidence call "self-serving declarations". If, in a court of law, such declarations are offered in evidence by the one who made them, they are generally rejected as not worthy of reliance and, consequently, are held inadmissible. The accounting profession, of course, is not bound by the law of evidence, but it should and, in fact, does view the client's representations in much the same light. Accountants generally agree that they may neither rely upon such representations nor limit the scope of their audits because they have been procured.

Why then do they obtain them? Accountants say they request inventory certificates to avoid oral misunderstandings and to assure cooperation by the client. In the opinion of the writer, these slight advantages are outweighed by the fact that the routine procurement of such certificates tends to impair the initiative and independence of the auditing staff. It would seem that the sounder view is that which deems it neither reasonable nor proper to rely upon representations concerning matters verifiable by independent investigation. Therefore, say its proponents, inventory certificates should not be obtained generally, but only when irregularities are suspected or when information is not otherwise obtainable. When suspicion has been aroused, they are requested merely to put management "on the spot" and possibly smoke out the truth. In such case, the certificate, if given, could naturally not be relied upon blindly and would certainly not lessen the required scope of the independent vertification, but it may give the auditor some leads not otherwise obtainable. In the second instance—namely, when information is not otherwise obtainable—procurement of such certificates is simply a last resort, acceptable only because they are better than nothing.

The client's written representations concerning recorded liabilities should be evaluated in the same light as inventory certificates. In the writer's opinion these, too, should not be obtained as a routine procedure. The unrecorded liabilities certificate, however, is in a different category. Procurement of this representation is not only proper but definitely advisable. While it is not a substitute for a proper examination and does not lessen the scope of the audit, it is an essential part of the over-all search for undisclosed liabilities and, moreover, affords concrete evidence that the auditor made the inquiries that reasonable care re-

quires of him. In other words, its value is not as evidence of the facts contained in it but rather as evidence of the exercise of due care by the auditor.

Comprehensive representations by management similarly may not be relied upon and lessen neither the scope of the audit nor the responsibility of the auditor. They, too, should not be obtained as routine procedure for the same reasons as are outlined above in the discussion of inventory certificates.

Written Representations by Third Parties

Turning to written representations by third parties, let us first consider opinions given by experts. Basically, an auditor's responsibility is limited to the province of his professional field and is not intended to extend to those other than his own. Since he is not a lawyer, engineer or architect, in those or similar areas he must and safely can rely on the opinions of independent, reputable, qualified experts in those fields, provided there is no reasonable ground to believe them untrue.

Last we come to third party confirmation of facts shown in the client's books and records. In this category are confirmations of receivables and payables, bank certificates, stock registrars' certificates, bond trustees' certificates and the like. These are in the nature of testimony by disinterested witnesses which, in the courts, is accorded the greatest weight. They should and do receive similar consideration from the accounting profession and, accordingly, should be obtained wherever practicable and reasonable. A custodian's certificate as to possession of securities would likewise seem worthy of reliance provided he is reputable and one who holds securities in the ordinary course of his business. Confirmations from public warehousemen and consignees, however, may not be accepted blindly, in view of their possible adverse interests arising out of the opportunities for theft and fraud. Hence, proper procedure requires, in addition, verification of their bona fides and financial responsibility.

Summary

To sum up, then:

Written representations from clients are unworthy of reliance but may be useful in disclosing information not discoverable from the books or from independent investigation. With the exception of the unrecorded liabilities certificate (whose procurement is generally advisable), they should not be requested as routine procedure, but only when omissions or falsifications are suspected.

Written representations from independent experts are useful in supplying skilled, independent opinions as to matters outside the auditor's province, and are ordinarily worthy of reliance. They should be obtained whenever reasonable diligence requires their procurement.

Written confirmations and certificates from debtors, creditors, banks, outside custodians of assets, and the like, provide verification of the correctness of the client's accounts from disinterested, independent sources. They are the best evidence available to the accountant and should be obtained whenever and wherever possible.

Robert Lancelot Cuthbert

By The Committee on History

Orrin Bishop Judd once wrote, "Biography is the fountain-head of history. As the waters of a thousand springs run, in confluent streams, from mountain-heights to the ocean; so the lives of individuals, coalescing in families, communities and nations, are merged in, and make up the general history of mankind." This is the brief story of the only member of our Society to make the supreme sacrifice in World War I.

As one leaves the elevator car at 677 Fifth Avenue to enter the offices of The New York State Society of Certified Public Accountants, he may see on the wall directly in front of him a bronze plaque which below an eagle bears the following legend.

"In memory of the
following members of the
New York State Society of
Certified Public Accountants
who made the supreme
sacrifice in World War II

* * * *

Charles Daum
Vernon L. Denby
William Coros
William Combrinck-Graham
Jack Hauser
Irving Levine
Alexander Saladuchin
Leo Taub
Richard C. Whitelocke

* * * *

and in honor of the
904 members who served
in the armed forces."

At September 30, 1945, about the end of the fighting, the membership of the Society was reported to be 4,892. Nearly 19% of that number were or had been in the armed services. And the losses by death of the 9 for whom the above described memorial was made were 1 out of 544 of the total membership.

At the end of World War I the membership was between 372 as at May 10, 1918, and 400 as at May 12, 1919, perhaps midway at 386. The number in the services was not reported. But the records show that of them one life was lost out of the membership of 386.

This is an appreciation of that single member who in that earlier conflict made the supreme sacrifice—

Robert Lancelot Cuthbert

What he was may be suggested by facts of his biography and confirmed by what was said of him by those who knew him well.

His father, Hugh Cuthbert, son of a well-known ship-owner of Greenock, Scotland, and his mother, Anne, daughter of Col. Sir Thomas Wilkinson, Knight Commander of the Star of India, were the parents of six sons and two daughters. One of the daughters and all six sons were in active military service, two sons in the Boer War in South Africa and four in World War I in which 2d. Lt. Reginald Vaux Cuthbert of the Seaforth Highlanders was killed in action.

Robert, the oldest child, was born in Greenock, Scotland, on June 19, 1868. He was educated at Wimbledon School near London and the University of Edinburgh. In continuation of his edu-

This is the ninth of a series of articles on the History of Accounting in the State of New York, prepared by the Society's Committee on History.

cation he served as an apprentice of A. & J. Robertson, Chartered Accountants of Edinburgh, from 1886 to 1891. Then upon an examination of the Scottish Institute in 1891, in which he was a prizeman, he became a Chartered Accountant of Edinburgh. Based upon this educational background and upon his experience in practice, which will be told a little later, he became New York Certified Public Accountant #16 in 1896, being one of the second group for which the examination was waived.

He came to New York probably early in 1894 and soon took out his papers for naturalization when about 26 years of age.

Before coming to the United States he had been employed by public accountants in London, perhaps Deloitte's from 1891 to 1893. Here in New York he practiced alone about 4 years, 1894-1897. In 1898 he and Frederick W. Menzies, CA, founded Cuthbert, Menzies & Co., which early in 1899 became Cuthbert, Boughey and Menzies (upon the addition to the firm of Frank M. Boughey, CA, CPA) to March 31, 1900.

From April 1, 1900, he resumed his practice alone through 1904; then was a partner in Deloitte, Plender, Griffiths & Co., from 1905 to 1911; and then of Arthur Young & Co. during 1912 to about May 1914, after which for a few months he resumed his individual practice. In 1914 he visited Great Britain and his practice of accountancy was ended. But it should be noted that beside his membership in the Society of Accountants in Edinburgh dating from 1891, he became a member of The New York State Society of CPAs, April 1897, and through that, of the American Association of Public Accountants in 1905, retaining all these memberships throughout his life.

But he was not one of the kind of accountants described by Elbert Hubbard. Though he never married, he mixed with men. His clubs were the Garden City, National and St. Andrews Golf Clubs, the City Club and St. Andrews Society of New York; and two yacht clubs, the New York and the Seawanhaka-Corinthian. Probably his greatest sports interest found expression in yachting, especially in small boats of which he owned several and raced them himself.

While Cuthbert was vacationing in London in the summer of 1914, World War I broke out. There is no record of his consideration of what that meant to him. Perhaps he thought of his grandfather in India, or of his two brothers who served in South Africa, or of his three brothers and a sister who then were or soon were to be in the present conflict. Was not that enough for one family? Besides, he was 46 years of age, and an American citizen. But persuasive arguments to the contrary, *noblesse oblige*.

There is a record that "to do his bit for the land of his birth he applied to a recruiting Sergeant who refused to believe he was as young as he stated. Cuthbert contended that no matter what his age was, he was physically able to endure the hardships of a soldier's life. The Sergeant, admiring his persistence, agreed to accept him if he could pass the doctor, and he did * * * he joined the 2nd King Edward's Horse, attached to the 1st Canadian Division, then in training at Windsor, and there he spent the winter and spring until his regiment was sent to France."

From there his story is short. "While engaged in particularly hazardous scout duty in Flanders he was shot on July 6, 1915 and died the next day."

Perhaps it was the result of their training or of some inherent disposition to stick to facts of record and to avoid statements of their own impressions, that accountants have said so little of him. The President of The New York State Society of CPAs in his annual report dated May 18, 1916, said: "Death has again claimed toll of our society and I have to announce the loss of four of our esteemed members during the past year." He named them,

one being Robert L. Cuthbert. No officer of the American Association of Public Accountants reported the losses by death which that society had sustained. The obituary in the *Journal of Accountancy* told only a little of his professional life and of his enlistment and death. The editor of *The Pace Student* went a little further and wrote that "Cuthbert's friends among American accountants will be greatly pained to learn the sad news."

But others outside his profession did not have such inhibitions. "His fellow soldiers spoke most highly of his courage and gallantry as a soldier and they missed him as a true friend and companion. His sunny disposition was always a help to his fellow soldiers." Those fellow soldiers had known him during only a few months. Extracts from records of a few of the organizations with which he was connected in New York reflect earlier opinions of him.

The Trustees of the Seawanhaka-Corinthian Yacht Club recorded:

> "His untiring energy and interest in the Club and its best attainments over a period of twelve years, as well as his enthusiasm and interest in the sport of yachting will long be remembered and appreciated, but the qualities which now truly endeared him to us were those of loyal friendship and true sportsmanship which makes his death so keenly felt by us. Therefore Resolved in his passing the members have lost a warm and loyal friend, an enthusiastic yachtsman, a keen sportsman and a charming companion."

The New York Yacht Club's Committee on Resolutions said:

> "In his death this Club has suffered an irreparable loss; he was an enthusiastic yachtsman, the master of his vessel, a corinthian. In the private relations of life his loss will be felt by those who best knew him. Always courteous, generous and mindful of the comfort and pleasure of others, it is not strange that he kept the affectionate regard of all with whom he came into contact. The members of the New York Yacht Club have lost a friend."

The Council of the University Settlement Society resolved:

> "Mr. Cuthbert had an interesting personality. He was a man of high character, great energy and unusual capacity; he had the warmest of human sympathies and an abounding generosity. He was capable of close friendship and had many friends. His many acts of unsolicited kindness to them will not soon be forgotten. His sense of duty was unusually keen . . . While a member of the Council, the Settlement enjoyed the benefit of Mr. Cuthbert's zealous, unselfish and effective work and it is fitting that this minute be made in testimony of the service he rendered, of the appreciation of the Council of his character and of its sincere sorrow on account of his untimely death."

Robert Lancelot Cuthbert, we, of those for whom you died, salute you!

New York State Tax Forum

Conducted by Benjamin Harrow, C.P.A.

Interest on Refunds—Income Tax

Sec. 377.4 was amended by the 1952 Legislature to provide that refunds of certain overpayments of personal income taxes shall be without interest.[1] There is some confusion in the minds of taxpayers as to the scope of this provision. Does it apply to all refunds of personal income tax or only to refunds made upon application of the taxpayer for revision or to refunds of additional assessments previously made by the Tax Commission.

The Attorney General recently rendered a formal opinion clarifying this amendment.[2] He states that where the Tax Commission examines a return and determines that the tax as computed by it is less than the amount shown on the return, the excess shall be refunded. The amendment applies to such a refund. Since there was no compulsion upon the taxpayer to pay such excess in the first instance, there would appear to be no obligation on the part of the State to pay interest when the excess is returned. As the Attorney General puts it,

> "Nothing compels the State to act as a depositary at interest for funds voluntary paid to it in excess of any obligation imposed by the statute . . ."

The amendment would also apply to a case where the taxpayer who has made an overpayment by reason of his own mistake files a claim for revision within the statutory period of two years, even before the Commission has had an opportunity to audit the return within the statutory period of three years.

However, there are situations where refunds will still be made with interest. One case is where the claim for revision is made to recover payments made under compulsion of statutory provisions claimed to be void or erroneous or illegal. Or the case where an additional assessment is made by the Commission and paid and the taxpayer then makes a claim to recover the tax. Such overpayments cannot be said to be voluntary and any refund would be with interest. A "right to interest follows a refund of taxes, paid under void laws or by virtue of erroneous or illegal exactions, made under a statute silent as to interest."[3]

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Mr. Harrow has been a member of the American Institute of Accountants since 1922 and is a member of the New York Bar. He is now serving as one of the Vice-Presidents of the Society and is also on the Society's Committee on Federal Taxation, and is past Chairman of its Committee on State Taxation. He is also a member of the Institute's Committee on Federal Taxation and its Council.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

Estate Tax—Refund of Overpayment

Sec. 249(y) of the Estate Tax law permits a discount of 5% if payment of the estate tax is made within six months of the death of decedent. A

1 Chapter 571, Laws of 1952.
2 July 17, 1952.
3 *Matter of O'Berry,* 179 N.Y. 285.

conscientious executor will usually estimate the estate tax and make payment within six months in order to get this discount. It frequently develops that the tax as finally computed is less than the estimated amount computed earlier. Obviously, the executor is entitled to a refund. However, he will not get the refund unless he applies for it within one year from the date of the order fixing the tax. A recent case has so held.[4]

In this case an estimated tax of $9,000.00 was paid on November 18, 1946. A pro forma order was filed in the Surrogate's Court of New York County on September 8, 1947. The tax was fixed at $8,792.29 less at 5% discount for prepayment, leaving a net tax of $8,352.68. The overpayment amounted to $647.32.

Under Sec. 249(a)(a) of the tax law a claim for the refund should have been made by September 8, 1948. The executors made no claim at the time for the reason that the federal tax had not yet been fixed and until that was done there could be no determination that any additional tax would be due to the state under Sec. 249(n) by reason of the maximum credit allowable to the estate against the federal estate tax. The federal tax was finally fixed on March 10, 1949, and it was then determined that no additional estate tax was due to New York.

The executors made a demand for a refund of the overpayment on March 16, 1949. This was refused as not timely. The executors then tried another procedure for getting the refund. On September 14, 1949, they tried to modify the original taxing order of September 8, 1947, and sought a supplemental determination under Art. 10 C, Sec. 249(w) of the Tax Law of the amount of any additional tax due under Sec. 249(n) of the tax law. By reason of the federal proceedings there was obviously no additional tax due, but the original taxing order had made no reference to the additional tax. The amended taxing order was filed on October 31, 1949. On September 13, 1949, the executor again demanded the refund and this was refused on February 13, 1952.

Said the court, a refund is dependent upon express legislative authority.[5] Such authority is contained in Sec. 249(a)(a) which provides that the application for the refund must be made within one year of the entry of the taxing order. The court has no power to require the Tax Commission to do something which the legislature has not empowered it to do.

Under Sec. 249(a)(a) a refund may be made where the fact of overpayment is established by a modification of the taxing order and such modification is made within two years from the date of the taxing order. The executor did not come within this provision either. The opinion ends with these words:

> "It necessarily follows that however sympathetic the court may be with the equity and justice of petitioner's claim, it is without power to grant the relief sought."

Significance of 'Combined' Reports

To the accountant a consolidated report has a definite technical significance. He knows for example that such a report must eliminate all intercompany transactions. In preparing a combined franchise tax return, having first obtained permission to do so, he will learn that a combined report is not really a consolidated report. The standard eliminations of intercompany transactions are not permitted. A combined report is literally what the word means, uniting in one report the net income of the included companies without intercompany eliminations, except for dividends and intercorporate stockholdings, bills, notes, accounts receivable and payable, and other intercorporate indebtedness. The advantage taxwise in filing a combined return will apply only if one company has a net

[4] *Guaranty Trust Co.* v. *Bates et al.*, Supreme Court, Albany County, July 17, 1952.

[5] *People ex rel. Bankers Trust Co.* v. *Graves,* 270 N.Y. 316.

loss and the other a net profit. There is no tax advantage if both companies have a net profit, except possibly for some advantage in obtaining a better allocation of income without the state. If Corporation A, for example, sells property to Corporation B, a closely affiliated corporation, at a profit, Corporation A will be taxed on the profit under the net income basis. (Art. 9A). Corporation B has acquired an asset which directly does not affect its net income. On a consolidated return this intercompany transaction would be eliminated and A's profit on the sale would be removed from the consolidated net income. But on a combined return the transaction is not eliminated and A's profit is part of combined net income and still subject to the franchise tax.

Accountants should be aware of this deviation from good accounting principles in considering the filing of a combined return under the franchise tax law. We might add that Art. 9A always provided for combined returns except for one year (1945) when the franchise tax law was completely revised. In the revision this was changed to consolidated returns, but the Commission was aware that the more technical term might be construed as a change in its practice and the law was amended eliminating the word consolidated and restoring the word combined.

Income Tax Deduction For a Loss on a Bill of Exchange

One of the assets of the estate of a decedent who died in 1938 was a non-interest bearing bill of exchange for 10,000 pounds signed by a London concern. The obligation was paid in 1945 in pounds deposited to the executor's credit in a London bank. It was held by the bank in a blocked sterling account which could not be converted into dollars. For estate tax purposes the bill of exchange was valued at $46,806.94. The executor claimed a loss on the collection of the bill of exchange of $6,406.94, representing the difference between the value in dollars at decedent's death and the value in dollars of 10,000 convertible pounds at the date of payment.

The Tax Court disallowed the deduction on the ground that it had not been shown that the decedent acquired the note in a transaction entered into for profit. On appeal to the circuit court the decision of the tax court was reversed,[6] Justice Frank dissenting. The court said that the estate was a separate and distinct taxpayer from the decedent. It was the duty of the executor to dispose of the asset on the best terms possible, not to hold it for personal use. The acquisition of an obligation by the executor in behalf of the estate was a transaction entered into for profit in the statutory sense. If he had received more than the amount at which it was valued for estate tax purposes, he would account to the estate for the profit. If a transaction entered into for profit resulted in a loss, the loss was therefore deductible.

Other aspects of the case are of interest. If there had been a profit on the payment, the executor could have deferred the inclusion of the gain to a year when the gain was made available, under the blocked currency rule. In the instant case when the pounds are actually converted into dollars, or otherwise made available, the difference between the official rate of exchange at the time of payment and the actual dollars received will represent either a gain or a further loss. In this writer's opinion the Tax Commission will most likely follow the holding of the circuit court.

Estate Tax—Payments Under Profit Sharing Plan

The General Counsel's office recently issued a memorandum[7] indicating that it will in the future (after July 1, 1952)

6 *Waterman's Estate* v. *Commissioner*, C.A. 2nd Circuit, March 5, 1952, 195 F(2nd) 244.
7 G.C.M. 27242 (I.R.B., May 12, 1952, p. 21).

include in the gross estate of a decedent amounts payable to a beneficiary under a profit sharing or retirement plan if the employee may designate a beneficiary of the death benefit, even though the employer has a right to cancel the designation of the beneficiary and the death benefits, provided the employer had not in fact cancelled such designation and death benefits.

This ruling modifies an earlier ruling[8] which held that if the employer could terminate or modify the plan, a death benefit was not includible in the employee's estate, either as property of the employee under Sec. 302(a)[9] (now Sec. 811(a)) or as life insurance under Sec. 302(g).[10] The Bureau's view at that time was that the employee had no contractual right to the death benefit. It now feels that the mere possibility that an employer might withdraw the right of the employee prior to his death to receive a death benefit does not indicate an absence of a property interest of the decedent. The new ruling will be applied to estates of decedents dying after June 30, 1952.

8 G.C.M. 14817 (C.B. 1937-1, 281).

9 Rev. Act of 1926.

10 *Ibid.*

Federal Tax Commentaries

(Continued from page 679)

return (the year was 1941), but that opposite Line 3 in the space provided for interest on bank deposits, etc., the taxpayer stated, "See attached," and annexed a "statement of income and expenses" of his fruit and produce business. He reported half the amount, about $8,600, in the space labeled "Net Income" (the other half being reported by his wife on her return) in the section provided for "Computation of Tax." The taxpayer did not contest the disallowance of about $16,000 in expenses, which was in excess of 25% of the gross income reported.

Some More on Charitable Gifts in Kind by Farmers

We disagreed in the June, 1952, issue of this periodical with Dean Griswold's article on charitable gifts. Professor Bittker, of Yale Law School, also disagreeing with Dean Griswold, suggests in the June, 1952, issue of Harvard Law Review that, if a farmer makes a gift to charity of farm products raised primarily for sale, the return for the year in which the expenses were deducted should be reopened and the expenses disallowed. He does not believe that legislation would be necessary, even if the intent to make the gift arose in a later year, his argument being that the expense of raising a crop that is not sold is simply not an ordinary and necessary exepense of carrying on business. His solution is nullified, however, by the Supreme Court decision in *Ellis R. Lewis,* 340 U.S. 590 (1951), which held that a tax return for a previous year may not be reopened to reflect a subsequent fact. The only correct method would seem to be the one we suggested, which was that the deductions be returned to income in the year of the gift.

Accounting at the S. E. C.

Conducted by Louis H. Rappaport, C.P.A.

Quarterly Reports to the SEC

Many companies now make quarterly reports to the SEC of sales and operating revenues. These reports are filed with the SEC and, if the company is listed, with stock exchanges. The form used for such reports is designated Form 9-K.

The SEC is considering a proposal to revise Form 9-K and the rules relating to the filing of quarterly reports on this form, and has asked for comments from interested persons *on or before November 10, 1952*, but it is probable that the Commission would welcome comments even at this date.

In lieu of the present obligation to report sales and revenues quarterly, the proposal would substitute a requirement for the filing after the close of each fiscal quarter (except the last quarter) of a report containing an income statement and a surplus statement. These statements would cover (i) the quarter, and (ii) the current fiscal year through the close of such quarter.

The required statements would be governed by Regulation S-X but would not have to be certified and none of the supporting schedules would be filed. However, all the compliance notes required by the regulation would have to be filed or incorporated by reference to annual reports filed or to be filed with the SEC.

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Material amounts of depreciation, depletion and amortization would have to be disclosed either in the statements or in notes. Disclosure would also be required as to material amounts of excise taxes included in sales.

Provision would also be made to permit the incorporation by reference of financial statements contained in proxy statements or quarterly reports to stockholders if they meet the requirements of the form, in which event a copy of the proxy statement or report to stockholders would be filed as an exhibit to Form 9-K.

Separate reports on Form 9-K would be required to be filed for each fiscal quarter, *except the fourth or final quarter,* of every fiscal year. The reports are due 45 days after the end of the quarter covered by the report.

Form 9-K does not have to be filed by any bank, bank holding company, insurance company (other than title insurance companies), investment company, common carrier, public utility company, or any company primarily engaged in the production and sale of a seasonal single-crop agricultural commodity. Under the proposal the exemption would also apply to certain commercial, industrial and mining companies in the promotional, exploratory, or development stage.

Notice of these proposals is contained in Release No. 4755 under the 1934 Act. It is believed that every company affected by the SEC proposals has received a copy of this release. Accountants might well consider, however, the advisability of calling this matter to the attention of those of their clients.

Notes on the New York State Unemployment Insurance Law

Conducted by Samuel S. Ress

Some Pointers in Handling Unemployment Insurance Disputes

How Disputes Arise

1. Benefit applications of alleged former employees may have been denied because of insufficient earnings in covered employment or the nature of the alleged employment, or the State in which the services had been performed. The reason for the former employee's unemployment may be in dispute. Was he laid off because of lack of work, an industrial controversy, misconduct, or for some other reason that may affect his right to benefits? Does the employer claim that the claimant was an independent contractor or that he (the employer) was exempt from filing reports and paying unemployment insurance taxes?

2. Audits by New York State Unemployment Insurance Payroll Examiners may have resulted in additional assessments or in the reduction of the amount of a tax refund which the employer claims.

3. Penalty assessments may have been received from Albany for alleged failure to file a timely L.O.12 report. (It must be filed within 7 days from the mailing date stamped on it.) The charge is $10 for each individual employee wage information request answered late. There are other $3 (per head) penalty assessments, with a ceiling of $500 for the failure to file a requested quarterly wage information report within 20 days, as specified in the request.

4. Determinations may have been made by the Unemployment Insurance Division that the employer is not entitled to an Experience Rating Tax reduction because of insufficient "age", or poor benefit experience, or for some other reason. An employer may have been incorrectly classified. He may believe that he is entitled to a lower rate than that assigned to him. A right to establish a joint account or to be considered the successor or not the successor of a former employer with poor experience may be involved.

5. There may have been a denial of a tax refund claim or an application for exemption from coverage by a new employer or a formerly covered employer.

6. There may have been an incorrect certification by the Unemployment Insurance Division to the Commissioner of Internal Revenue or to the Director of Internal Revenue of timely payment of contributions by the employer to the State Unemployment Insurance Fund, thereby resulting in an additional federal Unemployment Tax assessment levied by the Commissioner of Internal Revenue.

Samuel S. Ress has been as Associate Member of our Society since 1936, and is also a member of the Bar. He has specialized in the payroll tax field since the inception of this type of legislation in 1936.

Dr. Ress is a member of the Society's Committees on Clothing Manufacturing Accounting, on Labor and Management, and on State Taxation.

7. Special investigations may have been made by "fraud squad" examiners regarding alleged irregularities in reporting wages so as to permit employees to collect benefits to which they might not be otherwise entitled.

8. Tax warrants may have been issued, followed by visits of New York State tax collectors for alleged failure to pay taxes or penalties or interest, etc. If the taxpayer can't prove (by a cancelled check or some other record) that the item was paid, you may in a proper case enter into a deferred payment arrangement with the approval of the Division, if the client is financially embarrassed at the time. Bear in mind however that should payments due for one year extend beyond January 31st of the following year, the employer may be saddled with an additional Federal Unemployment Tax.

Steps to Be Taken

1. Avoid disputes. Find out what you are supposed to do and then do it. If you run short of time, apply for an extension of time. If there is some specific provision in the law allowing for additional time, mention it in your letter of application for an extension. More often it is easier to avoid incurring the penalty assessment before it is levied than to have it abated after it has been assessed and has become a matter of record. The New York State Unemployment Insurance Division maintains an office at 1440 Broadway, New York City, and also in Albany, N. Y. You may be able to get some further information regarding your matter from that source.

2. Answer all inquiries fully and on time.

3. If you dispute a determination or an order of the Unemployment Insurance Division, be sure to file your protest and demand a hearing within 20 days from the date stamped on the Determination Notice or you may find yourself barred from obtaining relief unless the Industrial Commissioner sees fit to grant you some discretionary relief; but don't bank on the latter.

4. After you file your protest and demand for a hearing, the matter may again be reviewed by the Determination and Liability Section. If it doesn't reverse its original determination, the file will be sent down to one of the Local Field Audit Offices maintained by the Division.

A conference will be arranged with the Principal Payroll Examiner or one of his deputies, at which time you have another opportunity to review the relevant papers in the file which led to the Industrial Commissioner's original determination. You may find that the file does not show all the facts and figures and you then have an opportunity to supply the additional information on the basis of which the Principal Payroll Examiner may recommend a change in the original determination. The Principal Payroll Examiner may convince you that you have no case and ask you to withdraw. You still have a right to have the matter determined by the Referee.

5. After you receive the Notice of Hearing before an Unemployment Insurance Referee (who does not represent the Unemployment Insurance Division) you may communicate with the New York State Hearing Representative attached to the Legal Counsel's Office and ask for a conference. It often happens that after the Hearing Representative goes through the file he may recommend that the original determination be withdrawn, either because he knows what the attitude of the Referees may be in certain types of disputed fact cases, or because of some new decision or change in the law that may affect your case.

6. The matter may then go forward to the Referee, who may not have seen the file in the case until a few minutes before your case is called. Present at the hearing are: the Referee, the official stenographer, the State's Hearing Representative, his witnesses, the client's representative and his wit-

nesses. All witnesses are sworn, and a verbatim record is made of all that takes place at the hearing. If the taxpayer has any testimony to offer or evidence to introduce be sure it gets into the record; otherwise he may never be able to include it without special permission. The Industrial Commissioner's witnesses may be examined and he may question the taxpayer's witnesses. The Referee generally takes an active role in the questioning. He is interested in eliciting all the facts needed to enable him to write a decision and make Findings of Fact and draw Conclusions of Law.

At the close of the hearing the taxpayer's representative should ask for permission to submit a brief or any additional evidence or record that may help the taxpayer's case. A copy of the brief must be served on the State Hearing Officer. If more time is needed, an adjournment should be sought.

7. The Appeal Board may review the Referee's Findings of Fact and Conclusions of Law if a Notice of Appeal is filed within 20 days from the date of the Referee's decision. Otherwise, the Referee's findings are final. The Appeal Board may review the record of the case and may not grant any further oral hearing. A brief may be filed after going over the transcript of the proceedings before the Referee.

Only questions of law may be appealed to the Appellate Division of the Supreme Court of the State of New York. Only special cases get to the Court of Appeals and the U. S. Supreme Court, but if the case is important enough it can go that far.

Office and Staff Management

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by Max Block, C.P.A.

Preparing for the Tax Season

It is not too early to start planning now for the personal income tax period ahead. Advance attention to arrangements will result in a more efficient operation, less strains, minimum overtime, and fewer errors and oversights.

At this time a calculation should be made of the number of Federal and State returns that may be prepared. As with any budget, these data should be used to estimate the time required for preparing, reviewing, typing, and proofreading returns. Based on the estimated time requirement, manpower needs can be ascertained and overtime schedules (if needed) worked out. Finally, the required supply of the tax blanks can be gauged and the responsibility for obtaining them on time assigned.

Drastic overtime should be avoided if at all possible. It is costly in dollars, errors, and staff morale. Sound planning and administration has accomplished material time savings for some accounting firms.

For the benefit of readers who would like to learn of recently published data on planning for the tax season, the following articles are recommended:

"Office Procedures for Controlling the Processing and Filing of Income Tax Returns", By Herbert B. Fischgrund—*New York Certified Public Accountant,* January 1949, p. 49.

"Some Hints with Respect to the Assembly of Tax Information and the Preparation of Tax Returns", By Hyman D. Klein—*New York Certified Public Accountant,* January 1949, p. 53.

Also see the discussion on tax department operations in the "Office and Staff Management" column in *The New York Certified Public Accountant* for the months of February, August, November, December, 1951, and January, March, April, May, July, 1952.

Max Block, C.P.A. (N.Y., Pa.) is a Director of the New York State Society of Certified Public Accountants and has been the Chairman of the Society's Committee on Administration of Accountants' Practice. He is a member of the firm of Anchin, Block & Anchin.

Personal Income Tax Questionnaires

Firms that are using questionnaire forms for the collection of personal income tax data are, in the main, deriving substantial benefits therefrom. This is true of firms preparing large and small numbers of returns.

The questionnaire contains queries designed to cover every point dealing with income, expense, capital transactions, exemptions, dependents, etc. It is used by the taxpayer as a checklist of data to be submitted to the accountant. The form serves in part as a worksheet and also as an authoritative, signed record of the data submitted by the taxpayer.

To obtain the maximum benefits from the form the following procedures are recommended:

(1) In October or November, mail the questionnaire to all taxpayers for whom you expect to prepare returns.

(2) An accompanying letter should explain the purpose of the form and the importance of obtaining all the re-

(Continued on page 703)

The Excess Profits Tax Exchange

Conducted by DAVID ZACK, C.P.A.

THIS department is a clearing house for questions, problems, comments and rulings regarding Excess Profits Taxes. We are especially interested in special and informal Bureau rulings on Excess Profits Taxes. All items of general interest will be published herein and full credit will be given all contributors unless they request otherwise. All inquiries and contributions should be addressed to:

Editor, The Excess Profits Tax Exchange
The New York Certified
Public Accountant
677 Fifth Avenue
New York 22, N. Y.

New Corporations

Herbert M. Haber, C.P.A. and attorney, submits a very thought-provoking question which indicates the difficulties involved in applying statutory language to a specific fact pattern. The question sets forth the following problem:

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>
> Mr. Zack is a Lecturer on Taxation at The City College (N. Y.) School of Business and Civic Administration and at the New York University Institute on Federal Taxation.
>
> Mr. Zack has written on tax matters for various publications. He is a partner in the firm of David Berdon & Co., Certified Public Accountants.

"The Joint Staff summary on amendments made to Code Section 430 by Section 501 of the Revenue Act of 1951 states:

'In determining how many years a new corporation has been engaged in business, the bill describes certain cases in which a new corporation is considered to be as old as the oldest of its predecessor corporations, or as old as the oldest of the other corporations with which it or its shareholders are related. In general these cases include the following:

4. Where the same stockholders control both the new corporation and another corporation which was engaged in a similar business.'

My problem is one of interpretation and seems to hinge on the significance of the word *was*. Is a special meaning given to the amendment by the use of the past tense in referring to the older corporation? The word *was* seems to imply that the older corporation is no longer engaged in the similar business—the new corporation having taken over the business of the old corporation. The practical effect of the above limitation is then to prevent the formation of corporations with a maximum one year life—a new corporation being organized every year to replace the old to take advantage of the reduced Excess Profits Tax new corporation rate.

But does the above amendment also affect the following case:

An old corporation has for years serviced the New York area exclusively. It organizes a wholly owned subsidiary to service the Pennsylvania area. Both corporations operate simultaneously, engaged in similar businesses in different areas. Is the Pennsylvania corporation entitled to use the reduced E. P. T. rate for new corporations?

From nowhere or no one have I received a satisfactory answer to the above question. Supposedly until the Commissioner releases his interpretation, we shall be left in the dark."

Section 430(e)(2) (B)(ii) states that:

"The taxpayer shall be considered to have been in existence and to have had

> taxable years for any period during which it or any corporation described in any clause of this subparagraph was in existence, and the taxpayer shall be considered to have commenced business on the earliest date on which it or any such corporation commenced business:
>
> * * *
>
> (ii) Any corporation if a group of not more than four persons who control the taxpayer at any time during the taxable year also controlled such corporation at any time during the period beginning twelve months preceding their acquisition of control of the taxpayer and ending with the close of the taxable year; but only if at any time during such period (and while such persons controlled such corporation) such corporation was engaged in a trade or business substantially similar to the trade or business of the taxpayer during the taxable year. For the purpose of this clause, the term 'control' means the ownership of more than 50 per centum of the total combined voting power of all classes of stock entitled to vote, or more than 50 per centum of the total value of shares of all classes of stock. A person shall not be considered a member of the group referred to in this clause unless during the period referred to in this clause he owns stock in such corporation at a time when the members of the group control such corporation and he owns stock in the taxpayer at a time when the members of the group control the taxpayer. For the purpose of this clause, the ownership of stock shall be determined in accordance with the provisions of section 503, except that constructive ownership under section 503(a)(2) shall be determined only with respect to the individual's spouse and minor children."

This writer cannot agree with Mr. Haber that the use of the word "was" indicates that the section applies only when the older corporation has discontinued the business which the "new" corporation has adopted. It would seem to us that the past tense was used in the statute solely because the subject reference is to the twelve month period preceding the acquisition of control. Again, it does not seem to this column that the sole purpose of the statutory limitation is to prevent the perennial organization of "one-year" corporations with a 5% excess profits tax limitation. We believe that the purpose of the statute is to prevent the extension of the "new" corporation ceiling rates to any corporation meeting the control tests whether or not the older corporation has discontinued its substantially similar trade or business. However, the questioner's point is very well taken and would represent a substantial advantage to some taxpayers, if sustained. We will have to await the issuance of the Regulations and perhaps the promulgation of rulings and adjudications of the courts before the issue can be considered resolved.

The question also raises a question of fact which will undoubtedly provoke much litigation in the future, namely, the application of the phrase "substantially similar to the trade or business of the taxpayer" to a particular fact pattern. This writer is certainly not ready to concede that a business which is restricted to the New York area is necessarily "substantially similar" to a business which services the Pennsylvania area exclusively.

Avoidance of Excess Profits Taxes

Preoccupation with the intricate complexities of the Excess Profits Tax law can easily cause one to lose sight of a very basic choice which is available to the taxpayer. The excess profits tariff is applied only to corporations, but certain corporations are specifically exempt from the tax by statute (Section 454 of the I.R.C.). The simplest choice is sometimes the best one and the liquidation of corporations in order to avoid excess profits taxes is certainly a relief measure which should not be overlooked. However, this is very strong medicine which can kill as well as cure and should be carefully administered only by a skilled and experienced practitioner.

The current excess profits taxpayer is in a better position than its World War II prototype in regard to partnership alternatives to excess profits tax-vulnerable corporations. The Revenue Act of 1951 added a new section to the Internal Revenue Code, (Section 191 of the I.R.C.) effective January 1, 1951, which will make it easier to split

income among members of the family group. In addition the present tax planner had the advantage of the split-income provisions for spouses as well as the new concessions for heads of households available for taxable years beginning after October 31, 1951. Therefore corporate dissolutions today may conceivably not result in the tremendous amount of family partnership litigation which stemmed from the World War II Excess Profits Tax Law.

Of course, the tax price exacted for this avoidance of excess profits taxes is the capital gains tax payable upon the dissolution of the corporation. Today, even this cost may be mitigated by a provision among the so-called tax-free sections of the Internal Revenue Code (Section 112(b)(7) of the I.R.C.).

The chameleon nature of some of the corporations exempt under Section 454 of the I.R.C. provides another opportunity for the avoidance of excess profits taxes. The taxpayer may be able to control its qualifications as a personal holding company, regulated investment company, etc. and thereby escape excess profits taxation. However, in these cases, the cure may be much worse than the disease, and the facts should be carefully reviewed from every perspective before any course of action is adopted.

Office and Staff Management

(Continued from page 700)

quired data early. In addition the letter should indicate, as applicable, either (a) that the staff accountant will, in the course of the next monthly audit, or at some other approximate date review the questionnaire replies with the taxpayer, or, (b) that the questionnaire be mailed to the accountant's office before a specified date.

(3) Staff men should be notified as to what questionnaires they should review in December or January.

(4) The staff men should call clients in advance of the audit date to advise them of the fact that he will review their personal income tax data on a specified date and to urge them to have it in as complete a state as possible.

(5) Whenever it is found, after review of the questionnaire, that additional data are required, the staff man should arrange to have the information mailed or brought to the office by the taxpayer on such day as the accountant will be there. On monthly audit jobs, the staff accountant may be charged with the full responsibility for the timely collection of personal income tax data.

(6) Where completed questionnaires are not reviewed with the auditors but are mailed to the office, the following procedures may be helpful:

(a) An office review of the questionnaire should be made, including a comparison with the prior year's return.

(b) By telephone, or by letter, the taxpayer is advised of additional information required, and questions arising from the comparison are raised.

(c) A date is set for the taxpayer to come to the office with all of the desired data. These dates should be arranged in such manner as to insure the smoothest functioning of the tax department.

(7) It will be found, with the passage of time, that taxpayers will become so familiar with the form that a large percentage will prepare them fully and accurately. This should be a considerable advantage in expediting the preparation of returns. In addition, staff men will, in time, find it progressively easier to review the questionnaires and speed up their delivery to the tax department.

Announcement of

1953 PRIZE ESSAY CONTEST!

The Board of Directors of the Society has authorized the Committee on Publications to conduct a prize essay contest among seniors and graduate students majoring in accountancy, duly enrolled in the colleges of New York State. The article may cover any topic in the field of accounting and/or auditing.

Prizes in the amount of $100 for the best article and $50 for the second best article are offered. In addition, the two winners and any others submitting papers worthy of honorable mention will receive a one-year subscription to *The New York Certified Public Accountant.*

The General Rules of the Contest are as follows:

All papers shall be original, and the manuscript shall be typed in duplicate on 8½ x 11 stationery on one side, double or triple space typing, and shall not be more than 6,000 words in length. Each contestant shall indicate the exact number of words in his paper at the end thereof.

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The name of the individual submitting the paper shall not appear thereon, nor should there be any other means of identifying the manuscript, which should be accompanied by a covering letter giving the contestant's name and address. When submitted to the judges, each manuscript will be given a key number for identification.

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Manuscripts should be forwarded to The Managing Editor of *The New York Certified Public Accountant,* 677 Fifth Avenue, New York 22, N. Y., on or before May 15, 1953. Awards will be announced as soon thereafter as possible.

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All papers submitted shall become the property of the New York State Society of Certified Public Accountants and shall be available for publication in *The New York Certified Public Accountant.* The decision of the judges shall be final as to what papers, if any, may be entitled to prizes.

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